The Constitutional Division of Powers

An Economic Perspective

1992

The Economic Council of Canada is an independent advisory body with broad terms of reference to study, advise, and report on an extensive range of matters relating to Canada's medium- and long-term economic development. The Council is a departmental corporation consisting of a Chairman, two directors, and not more than twenty-five members.

The Council, as a corporate body, bears final responsibility for the contents of the *Annual Review* and of certain other publications that are clearly designated as *Council reports* or *Council statements*. The Council also publishes other material that is clearly attributed to individual authors rather than to the Council as a whole. Those publications fall into three categories: *research monographs*, *conference proceedings*, and *working papers*. While the Council has established a general policy regarding these three categories, it is the Chairman of the Council who bears final responsibility for the decision to publish them under the imprint of the Council.

The Chairman, in reaching a judgment on the competence and relevance of each author-attributed study or paper, is advised by the Economic Council's two directors. In addition, for authored research monographs, the Chairman and the two directors weigh the views of expert readers, who report in confidence on the quality of the work. Publication of an author-attributed study or paper signifies that it is deemed a competent treatment worthy of public consideration, but it does not imply endorsement of conclusions or recommendations by either the Chairman or Council members.

The Constitutional Division of Powers

Canadian Cataloguing in Publication Data

Boadway, Robin W., 1943-

The constitutional division of powers: an economic
perspective

Issued also in French under title: La répartition
constitutionnelle des pouvoirs vue sous l'angle économique.
Includes bibliographical references.
ISBN 0-660-14280-5
DSS cat. no. EC22-178/1992E

1. Canada – Economic policy.
2. Canada – Constitutional law – Amendments.
3. Federal-provincial fiscal relations – Canada.
I. Economic Council of Canada. II. Title.

HC115.B62 1991 338.971 C92-099520-9

ROBIN BOADWAY

The Constitutional Division of Powers

An Economic Perspective

The findings of this study are the personal responsibility of the author and, as such, have not been endorsed by the Members of the Economic Council of Canada.

© Minister of Supply and Services Canada 1992

Available in Canada through

Associated Bookstores
and other booksellers

or by mail from

Canada Communication Group – Publishing
Ottawa, Canada K1A 0S9

Catalogue No. EC22-178/1992E
ISBN 0-660-14280-5

Contents

Acknowledgments vii

Foreword ix

1 Introduction 1

2 The Role of Government in a Market Economy 3

3 Institutional, Policy, and Factual Background 7
- Federal-Provincial Fiscal Relations 7
- Constitutional Changes and Interpretations 14
- Recent Federal Policy Initiatives 18
  - Deficit Reduction Measures 18
  - Introduction of the Goods and Services Tax 18
  - The Operation of the Tax Collection Agreements 19
  - Structural Changes in Established Programs Financing and Equalization 19
  - International Developments 20
  - Federal Energy Policies 21

4 Efficiency in a Federal Economy 23
- The Internal Common Market 23
- Local Public Goods and Externalities 25
- Fiscal Efficiency 26
- Tax Harmonization 27
- Expenditure Harmonization 28

5 Equity in a Federal Economy 29
- Federal versus Provincial Responsibility for Equity 31
- Fiscal Equity 32

6 The Division of Economic Responsibilities 33
- General Principles Affecting the Assignment of Functions 34
  - The Assignment of Equity 34
  - Spillovers and Public Goods 34
  - Provision of Quasi-Private Goods 35
  - Regulating the Internal Common Market 36
  - Tax and Expenditure Harmonization 37
  - Transfers and Social Insurance 38
  - Other Issues Arising from the Federal Responsibility for Equity 38
- Consequences for the Assignment of Powers 38

- **7 The Economic Rationale for Federal-Provincial Transfers** 45
  - Some Institutional Background 45
    - Equalization 45
    - Established Programs Financing 46
    - The Tax Collection Agreements 47
    - Conditional Grant Programs 48
  - Economic Arguments for Federal-Provincial Transfers 48
    - Fiscal Gap 49
    - Fiscal Inequity 49
    - Fiscal Inefficiency 50
    - Interprovincial Spillovers 50
  - The Existing System of Transfers in Light of the Economic Arguments 51
    - Equalization 51
    - Established Programs Financing 52
    - The Canada Assistance Plan 55
    - The Tax Collection Agreements 56

- **8 The Financial Consequences of Alternative Scenarios** 59
  - A Decentralized Federation 59
    - Transfers to Individuals 59
    - Transfers to Firms 60
    - Expenditures on Goods and Services 60
    - Transfers to Governments 60
    - Tax Assignment 61
    - Regulatory Functions 62
  - A Reallocation of Responsibilities 63
    - Reassigning Tax Responsibilities 63
    - Transfers to Governments 63
    - Transfers to Persons and Firms 64
    - Regulatory Policies 64
  - Asymmetric Federalism 64
    - Implications for the Economic Union 64
    - Implications for National Equity 66

- **Notes** 67

- **References** 69

Tables

- 3-1 Federal Government Expenditures as a Percentage of GDP, 1961-88 8
- 3-2 Provincial Government Expenditures as a Percentage of GDP, 1961-88 9
- 3-3 Consolidated Provincial-Local Government Expenditures as a Percentage of GDP, 1961-88 10
- 3-4 Federal Government Revenue as a Percentage of GDP, 1960-90 11
- 3-5 Provincial Government Revenue as a Percentage of GDP, 1960-90 12
- 3-6 Ratio of Federal to Provincial Levels of Activity, 1961-90 13

Acknowledgments

I am grateful to Alan Douglas for his valuable assistance in the preparation of this study. Helpful comments were received from two anonymous referees as well as from members of the Economic Council of Canada's research staff.

Foreword

This study was commissioned as part of the research effort that led to the publication of the Economic Council's 28th Annual Review, *A Joint Venture*. The Review assessed the nature of the economic linkages among the provinces and discussed various aspects of policy harmonization within the union. It also investigated the fiscal relationships between the provinces and the federal government and debated key issues such as the appropriateness of national standards, the allocation of powers between levels of government, and the problems created by overlapping jurisdictions. The last part of the Review was devoted to a qualitative and quantitative assessment of some of the costs and benefits attached to various political models that could emerge from the current constitutional debate. Issues relating to the transition phases towards a new form of confederation were also discussed.

In this study, which served as a background to the section on the fiscal relationships between the provinces and the federal government, Professor Boadway analyses the economic rationales for the allocation of responsibilities among levels of government in a federal system. Efficiency and equity considerations are used as yardsticks for evaluating alternative allocations of powers.

The study focuses its discussion of efficiency considerations on various aspects of the economic union, particularly the need to ensure an internal common market by minimizing barriers to trade, investment, and mobility and the need for some form of equalization among provinces with substantially different economic structures. Efficiency considerations are seldom clear cut, however, and the study reviews a number of different efficiency arguments, some of which point in the direction of centralized government action, while others point towards decentralization.

Equity considerations are also an important yardstick for the distribution of powers since a great deal of what governments do – particularly in terms of their tax and spending policies – is implicitly or explicitly redistributive in nature. Here also, however, the lessons to be drawn in evaluating alternative allocations of power are varied. They depend significantly on one's personal view of what is equitable, and there is no simple way to derive a single "ideal" vision of equity in a society where there are significant differences among individuals on this question.

The study also reviews the evolution of the relative importance of federal and provincial activity in the area of taxation and spending over the last 30 years, noting the steady rise in the importance of the provinces over that time. It argues that these trends – accentuated by the federal budgetary restraint of recent years – may have a significant impact on federal-provincial fiscal relations in the future, particularly in terms of the ability of the federal government to exert an influence in the direction of harmonized tax and spending policies across the country.

The role of federal-provincial transfers and federal-provincial tax collection agreements is the subject of a thorough discussion in the paper, which points out the key role these have played in Canada in equalizing the fiscal capacities of the regions and in promoting national standards and the coordination of the tax system. In particular, Boadway develops various efficiency and equity rationales for these features of the federal-provincial fiscal relations system, with a particular focus on the circumstances in which cost-sharing arrangements and conditional grants might be appropriate.

Finally, the paper looks at some of the financial consequences of three different kinds of possible constitutional reform: one-way symmetric decentralization; two-way reallocation of responsibilities; and asymmetric decentralization to Quebec alone.

The expertise and insights provided by Robin Boadway through this study have been a major source of information and inspiration for the development of the Council's 28th Annual Review discussion on the state of fiscal federalism in Canada.

Robin Boadway is the Sir Edward Peacock Professor of Economics at Queen's University in Kingston and is one of Canada's foremost experts in the area of public finance. He is a frequent participant in the contemporary academic debate on the economic aspects of constitutional change in Canada.

Judith Maxwell
Chairman.

The Constitutional Division of Powers

1 Introduction

The ultimate purpose of this study is to discuss from an economic perspective issues in the reform of the constitution, with a particular focus on the division of powers. To make that discussion meaningful, some background material must first be presented. The constitution is about how governments are allowed, or are obliged, to operate. In a federal system, this must include how economic functions are assigned to different levels of government. A precondition for considering how constitutions should spell out the responsibilities of government is to discuss the role of government in a market economy. Knowing what the governments should do will help to determine what should be specified in the constitution and what should be left as a matter of Parliamentary decision.

We begin in the next chapter with a relatively short discussion of the role of government in a market economy. It can be a concise presentation since most of the arguments are well known and readily available elsewhere. The discussion must include not only the role of government in general, but also the role of various levels of government in a federal system such as that of Canada. By its very nature this discussion must be a bit open-ended. There is no scientific answer to the division of powers issue from an economic perspective. Some judgment must be made, and it is clear that economists themselves do not make uniform judgments on this issue. What we would hope to do is to present the issues in a clear enough way to allow the reader to make an informed judgment.

Subsequent to this discussion of the role of government, we spend some time presenting some institutional background to the current debate. This consists of material in three different areas. First, we discuss the evolution of federal-provincial fiscal relations in the past several years, both from the point of view of purely financial relations and from the point of view of the evolution of economic responsibilities. This will show the extent to which decentralization has or has not taken place in various areas of government decision making. Next, we briefly review some of the changes that have taken place on the constitutional front. This includes especially the Constitution Act of 1982, which has potentially important implications for federal-provincial fiscal relations, but also recent court decisions which have a bearing on constitutional issues. Third, we report on various policy changes in the past few years which have implications for federal-provincial fiscal relations. This institutional background will serve as a backdrop for discussing in more detail economic policy-making in a federal economy from the point of view of traditional economic criteria – efficiency and equity. The analysis of the division of powers is discussed in this context, and special consideration is given to two aspects of the financial relationship between the federal and provincial governments – federal-provincial transfers and tax harmonization. Finally, a discussion and evaluation of some of the alternative scenarios that have appeared recently will be presented, emphasizing their economic features.

2 The Role of Government in a Market Economy

The purpose of this chapter is to discuss the rationale for government activity in the economy. We begin from the presumption that we wish to preserve the advantages of the market economy. If organized in a competitive manner, the private sector with its decentralized decision making is an efficient allocator of resources and should be relied on wherever possible as a mechanism for determining how society's scarce resources ought to be used. From this perspective, the role of government can be viewed as correcting for the perceived failings of the market. We discuss later the nature of those market failures. They provide necessary, but not sufficient, conditions for government intervention. Depending on one's view of government, the sufficient conditions may or may not be satisfied in various circumstances. One can view government as a relatively benevolent institution and presume that government will be able to correct for most sorts of market failure as well as to facilitate the use of the market itself. Or, one may take the view of the so-called *public choice* school of economists and treat government not as benevolent, but as essentially self-interested and constrained only by democratic forces. This view stresses the tendencies for government to do harm and to make matters worse. In either case, the rationale for government intervention involves trading off the perceived benefits of decentralized individual decision making against those of collective decision making. Both views recognize the importance of private property rights for the functioning of the market economy.

Disagreement over the ability of the government to correct for market failures rests partly on what is, in principle, an empirical question – i.e., can government intervention succeed in improving the efficiency of the market economy in a given set of circumstances? However, there will be a more profound source of disagreement which rests not on objective fact, but on judgment. As outlined subsequently, one of the key functions of government, perhaps the most important one, is a redistributive one. As we will have the occasion to observe repeatedly, many of the things governments actually do are redistributive in nature as well as in intent. Many persons who view government as a device for the self-interest of those controlling it also abhor the use of government for redistributive purposes. Thus the public choice school would prefer as small a state as possible both for efficiency reasons and for redistributive reasons. Those who view the government from a more beneficial perspective tend also to put more weight on the redistributive role of government. It will become clear in what follows that the weight one puts on redistribution has an important consequence for the desired division of responsibilities between the two levels of government. In some cases, arguments for decentralization tend to be based on a desire for less government in general, and for less redistributive activity in particular. The opposite also applies.

Since the role of government depends upon compensating for the shortcomings of the market, it is worth summarizing the sources of market failure and inequitable outcomes that have been emphasized in the study of public finance. These are fully documented in the literature, so we can discuss them in a fairly concise way. These sources of market failure should be seen in the context of the so-called *two fundamental theorems of welfare economics* which summarize the strengths of the competitive market mechanism. The first of these theorems states that, in a certain set of idealized circumstances, the market, if operating competitively, will yield a Pareto efficient outcome – i.e., it will yield an allocation of resources such that no other allocation can be found which makes someone better off without making at least one person worse off. In economic terminology, all possible *gains from trade* have been exhausted. The second states that any Pareto optimal allocation of resources can be achieved by a competitive market mechanism combined with a suitable redistribution of initial wealth among households. Different Pareto efficient allocations will differ from one another in having a different distribution of well-being among persons in the economy. Given this starting point, the role for government rests on two things – first, the idealized circumstances may not hold so that the private sector cannot exhaust all possible gains from trade (the market failure argument); and, second, the market outcome, no matter how efficient it may be, is not equitable. Given this background, the reasons for government intervention can be summarized in the following list.

Public Goods — Public goods are those characterized by jointness of consumption and, in some cases, by nonexcludability – i.e., unlike with private goods, the same expenditure simultaneously benefits several persons, and it may be prohibitively costly to exclude persons who do not pay a price for its use. Markets cannot be relied on to provide efficient amounts of goods which are simultaneously consumed by several persons, with or without excludability. This is the traditional argument for government provision of goods and services. In fact, very little of what is called government expenditures represent spending on public goods. Yet, much of the theory of government expenditure, including that which has been used in the theory of fiscal federalism, has focused on situations in which government expenditures consist of public goods.

Externalities — Related to the above is the case where activities of some firms or households cause beneficial or detrimental effects on other firms or households, but which do not get priced for one reason or another. These are special cases of the joint-consumption property. Governments may respond by assuming responsibility for their provision or by using corrective mechanisms such as taxes (subsidies) or quantity regulations. The use of corrective mechanisms typically will not involve significant budgetary expenditures, so has relatively little implications for federal-provincial fiscal relationships in a federation. On the other hand, they could raise significant revenues (e.g., environmental taxes); so, to that extent, their assignment to level of government could be important.

Economies of Scale — The cost efficient scale of output of a good or service may be large relative to the market being served, in which case competition will not prevail. Unfettered private provision would result in an inefficiently low level of provision and the existence of positive profits. Again, governments may undertake to provide the good or service itself in an effort to attain a more efficient level of output. Alternatively, it may regulate private provision by stipulating prices or rates of return that can be earned. (Or, it may do nothing as some economists would advocate.) A complicating feature is that in the presence of increasing returns to scale, an efficient output requires operating at a loss. Thus revenues would have to be found to support such industries if it were desired to produce with full economic efficiency.

Unemployed Resources — There may be problems of coordination on some markets which imply that some resources go unused. Examples of this include labour, housing, and capital. There has been some theoretical work which suggests that there are systematic sources of inefficiency on these markets which government intervention can, in principle, correct (e.g., search externalities on labour and housing markets). [See, for example, Diamond 1981.] Analogous to this, there may be aggregate shortages of some types of factors or goods. Labour markets may also be made to function more smoothly by microeconomic policies directed specifically at those markets. An example is unemployment insurance. Macroeconomic policies can also be looked at as instruments for coordination of aggregate supplies and demands on goods and factor markets.

Absence of Full Markets in Uncertainty — A fully efficient allocation of resources requires that risks be fully traded and diversified away to the extent possible. This may not occur for a variety of reasons. For one, markets may be simply too thin for some types of risks, given the transactions costs involved. For another, a great deal of risk may be induced by uncertainty about government behaviour itself. Presumably this is not fully diversifiable. This may also be an important rationale for such things as unemployment insurance. Since the government itself may be inducing risk of unemployment, this risk may not be insurable on private insurance markets. Finally, risk markets may not function perfectly because of informational problems as discussed in the next category.

Asymmetric Information — It is now widely acknowledged that many markets are characterized by what is referred to as *asymmetric information* problems, meaning that one side of the market is better informed than the other. This implies that resources will not be allocated in their most efficient way. The two most common versions of this are *moral hazard* and *adverse selection*, and they have been analysed most extensively on insurance markets. However, they apply on many sorts of markets, including the markets for labour and capital. Basically, moral hazard refers to a situation in which one side of the market can take actions which affect the outcome, but which cannot be observed by the other side. Market outcomes may well involve a nonoptimal amount of such actions. Adverse selection occurs when participants on one side of the market differ from one another in some characteristic that is not observable to the other side. Such markets are known to yield inefficient outcomes and perhaps even to preclude equilibrium outcomes. There is a considerable literature on market failure resulting from adverse selection and moral hazard. What has not been established in the literature is whether this sort of market failure can be averted by public-sector intervention. For example, the public sector is likely to face exactly the same sorts of difficulties in becoming informed as the private sector. Thus it may not be possible for the government to improve upon the market solution for such things as health and unemployment insurance, at least on efficiency grounds. We have to look elsewhere for a rationale for major government intervention in these areas. The most likely reasons have to do with equity arguments which the final two items address.

Unequal Incomes — Even if markets were allocating resources in a perfectly efficient way, the outcome may not be regarded as being optimal if it results in allocations which are unequal. Governments may therefore wish to interfere to redistribute resources on equity grounds. These last two categories look at equity in two related ways. One indicator of inequality is simply differences in observed incomes among households generated by the market. These differences may come from several sources including the following: abilities, inheritances, human capital accumulated, work effort, and pure market luck. Virtually all governments engage in tax-transfer policies which redistribute income from the better-off to the worse-off households. However, there is a limit in the extent to which redistribution on the basis of income can be effective at achieving equity. There are two basic reasons for this. The first is that income may be a very imperfect indicator of well-being, especially since it does not reflect differences in, say, leisure and household production. The second is that, for any given household, income is an endogenous concept. Persons can change their income by altering their behaviour thereby causing inefficiency. The public finance literature has argued quite convincingly that the extent of redistribution that one can achieve by income-based instruments alone is likely to be quite limited [see Mirrlees 1971; Roberts 1984; and Tuomala 1990].

Social Insurance — There are, however, other arguments for redistribution which are related to the above but which recognize the possible usefulness of other sorts of instruments. The literature on redistributive income taxation tends to emphasize differences in the ability to earn income as a source of inequality. There are many other characteristics which also can result in utility differences and which can be (and, in practice, are) used as a basis for redistribution. They include such things as health and physical characteristics, employment status, location of residence, and date of birth. Redistribution based on these features is sometimes referred to as *social insurance* for the following reason. The endowment of each person with them is largely a matter of luck. If persons could purchase insurance against being unlucky in these characteristics, they surely would. However, they obviously cannot do so on ordinary insurance markets. Insurance can only be purchased before the event being insured against is revealed; and in this case, that occurs at birth. Thus they can only be "insured" against after the fact by the public sector. The conceptual device of putting oneself behind the "veil of ignorance" –, i.e., imagining not knowing what one's characteristics are going to be and asking what kind of insurance one would be willing to purchase is often used as a normative justification for compensating persons who have been unlucky at birth. This might be used as the justification for public health insurance, unemployment insurance, assistance to the disabled, intergenerational transfers in favour of unlucky cohorts, and so on. In each of these cases, the object of redistribution is somewhat different than income. Depending upon how sharply the government can observe the underlying characteristics, the possible induced inefficiencies in behaviour may be greater or less.

It is important to recognize that some of these things involve increasing the size of the "economic pie" and some involve redistributing the pie. Although the two are rarely separable, it is convenient to think conceptually of the former as being the *efficiency* role of government and the latter the *equity* role. The former involves exploiting those gains from trade which, for one reason or another, the private sector has not been able to exhaust; the latter involves the dividing up of the gains. Minimalists, including many public-choice theorists (e.g., James Buchanan), lay almost complete emphasis on the efficiency role of government[1] – i.e., they view government as an instrument by which gains from trade can be achieved collectively which the market is not able fully to exploit (e.g., because of public goods and externalities). How the gains obtained from collective action are to be distributed is not discussed, even though they may be sizable. Even in a minimalist state where the only function of the government is to protect private property, the collective gains may be substantial. The issue of how to divide them cannot be avoided. That constitutes the equity role of government.

One might also distinguish a third role of government, the *stabilization* role, from the efficiency and equity roles; although again the three roles will be interdependent. Much of our discussion will focus on the efficiency and equity aspects of government, though stabilization issues are undoubtedly also important for the constitutional debate. Several issues are involved, and we will do no more than mention them here, leaving their analysis to others. Perhaps the overriding issue is the nature of the monetary union that should exist in the federation. Canada may or may not constitute an optimal currency area. If it does not, but if a single currency must be used for other reasons, monetary policy must necessarily be a compromise among the various regional interests. To affect the compromise, it may be useful to ensure that regional interests are heard in policymaking in the central bank. Another issue is the extent to which the huge federal debt is a consequence of the existing division of powers and compromises the ability to undertake stabilization policy at the federal level. The ability of the federal government to undertake effective fiscal policy itself depends upon the degree of centralization of financial powers, presumably especially taxes and transfers. As the fiscal system has become more and more decentralized over the postwar period, provincial budgetary actions have become more and more important. Unfortunately, there is little apparent coordination of provincial and federal fiscal policies; and the possibility exists that they can be counteracting one another. Part of this can be resolved by consultative procedures, such as the one built into the Meech Lake Accord. As we have said, these issues are all important in evaluating the desirable extent of decentralization of the federation. Unfortunately, we have to leave that to others.

A fundamental characteristic of the pursuit of efficiency and equity, and this reflects their interdependence, is the inherent trade-off between the two objectives. The process of redistributing from the rich to the poor can only be accompanied by some loss in output, the loss being greater the more the redistribution. This is because of the adverse effects that the redistribution has on incentives (of both the donors and recipients). The issue of how redistributive the tax system ought to be, given this trade-off, has been the subject of considerable economic research. The analysis can be technically very complicated. At the risk of some simplification, one of the important qualitative lessons that has been learned from the literature is that the ideal amount of progressivity of the tax-transfer system is surprisingly limited.[2] Constitutions should recognize this in the sense that it would be unwise to impose absolute equity/equality obligations on the government.

At the same time, it should also be realized that equity objectives can be pursued by other means, some of which are as effective as taxes and transfers. Many components of the expenditure side of the budget have a redistributive element to them, whether or not that is their primary function. Examples include education, health care and insurance, welfare services, unemployment insurance, workmen's compensation, and the like. Indeed, given the limited extent to which taxes can, or do, redistribute, one could argue that government expenditures are first and foremost instruments for massive redistribution. Recognition of the extent of the redistribution inherent in what governments do is critical for designing a federal constitution, and we will come back to this later.

The economic principles behind the division of powers amount ultimately to applying the efficiency and equity roles of government to a federal context. Before doing so, it is worth first putting the discussion into a Canadian context by presenting some stylized features of the Canadian federation.

3 Institutional, Policy, and Factual Background

In this chapter, we discuss in a fairly general way the evolution of the institutional setting in the Canadian federation in recent years. The discussion is divided into three interrelated parts. In the first one, we focus on the financial relations including both the relative changes in expenditure and revenue-raising responsibilities, as well as the relative role of federal-provincial transfers and the occupancy of tax room of various sorts by the two levels of government. In the second part, the focus will be on events of a constitutional nature that will have an impact on federal-provincial fiscal relations. Here, the main focus will be on past changes in the constitution and new interpretations of the constitution by the courts. The prospect of future changes will be deferred until a later section. In the final part, some of the policy initiatives of the federal government, which have a bearing on federal-provincial fiscal relations, will be discussed. In all three parts, the discussion will be primarily descriptive, though an attempt will be made to point out some of the consequences of the various changes that have been occurring; consequences that will be discussed in much greater detail later on.

Federal-Provincial Fiscal Relations

This section provides background data on the evolution of fiscal relations between the federal and provincial governments over the last 30 years, including changes in expenditure and revenue-raising responsibilities, the role of federal-provincial transfers, and the occupancy of tax room represented by the transfers.

Tables 3-1 and 3-2 present federal and provincial government expenditures, respectively, as a percentage of gross domestic product (GDP) over the period 1961-88. Table 3-1 shows that total federal expenditures have grown from an average of 15.9 per cent of GDP during 1961-64 to 22.3 per cent during 1985-88. This growth is due to increases in debt service and in transfers, which have more than offset a decrease (relative to GDP) in spending on goods and services. As the table shows, debt service remained fairly constant at approximately 1.9 per cent of GDP from 1961-64, but increased significantly in the last 15 years to an average of 5.2 per cent in the late 1980s. Total transfers from the federal government (columns 1-3) have increased from an average of 8.1 per cent during 1961-64 to 12.6 per cent during 1985-88. Of particular interest is column 3, indicating a positive trend in transfers to provincial and local governments. These transfers have increased from an average of 2.5 per cent in the first part of the 1960s to 4.2 per cent in the latter part of the 1980s. An important part of this increase is due to transfers for health, education, and welfare.

Table 3-2 presents similar data for provincial expenditures as a percentage of GDP. This table indicates a far more dramatic increase in total provincial expenditures (which does not include local government spending) than in total federal spending. Provincial expenditures have increased from an average of 8.7 per cent of GDP in the early 1960s to 20.3 per cent in the late 1980s. This increase is comprised from increases in all of the broad categories of provincial spending, including spending on goods and services (which includes expenditures on education and welfare). Adding to the increase in transfers to local governments (column 3) are provincial contributions to municipalities for hospitals. While Table 3-2 includes only provincial government expenditures, Table 3-3 provides the same data with local expenditures included. Similar patterns emerge. Provincial-local expenditures combined rise from an average of 16 per cent of GDP in the early 1960s to almost 30 per cent by the late 1980s. This is substantially in excess of federal government spending.

Federal and provincial government revenues as a percentage of GDP are presented in Tables 3-4 and 3-5, respectively. Table 3-4 indicates that total federal revenues have increased over the last 30 years from an average of 15.5 per cent during 1960-65 to 18.3 per cent during 1986-90. As the first column indicates, the main source of the increased federal revenue was higher personal income taxes, which increased from an average of 4.7 per cent in the first half of the 1960s to 8.3 per cent in the last half of the 1980s. While the increase in personal income taxes was offset by a decrease in corporate income taxes from 3.1 per cent during 1960-65 to 1.9 per cent during 1986-90, federal government direct taxes still increased as a proportion of GDP. Columns 3 and 4 show that federal indirect taxes (sales and excise taxes) have decreased as a percentage of GDP. However, this trend has begun to reverse during the 1980s, and indirect taxes are likely to become more important with the implementation of the Goods and Services Tax (GST).

Table 3-1

Federal Government Expenditures as a Percentage of GDP, 1961-88

	Transfers to:					
	Individual (1)	Business (2)	Governments (3)	Goods and services (4)	Debt service (5)	Total (6)
			(Per cent)			
1961	4.9	0.9	2.8	6.3	1.9	16.9
1962	4.8	1.0	2.6	6.1	1.9	16.3
1963	4.5	1.1	2.5	5.5	2.0	15.5
1964	4.3	1.1	2.4	5.3	1.9	15.0
1965	4.0	1.0	2.5	4.9	1.8	14.3
1966	3.9	1.2	2.6	5.1	1.8	14.5
1967	4.2	1.2	2.9	5.2	1.8	15.3
1968	4.4	1.1	3.1	5.2	1.9	15.6
1969	4.3	1.1	3.3	5.1	1.9	15.7
1970	4.6	1.1	3.8	5.1	2.1	16.6
1971	4.8	1.0	4.4	5.1	2.0	17.4
1972	5.7	1.0	4.2	5.0	2.1	17.9
1973	5.5	1.0	3.8	4.7	2.0	17.0
1974	5.7	1.8	4.1	4.8	1.9	18.3
1975	6.2	2.4	4.5	4.9	2.2	20.2
1976	5.8	1.7	4.3	4.9	2.3	19.1
1977	6.0	1.6	4.6	5.1	2.3	19.7
1978	6.1	1.7	4.5	5.0	2.7	19.8
1979	5.3	1.7	4.3	4.6	2.9	18.8
1980	5.3	2.3	4.1	4.5	3.2	19.5
1981	5.2	2.4	4.0	4.6	3.9	20.1
1982	6.5	2.5	4.2	5.0	4.5	22.7
1983	6.9	2.6	4.3	4.8	4.3	23.0
1984	6.7	2.8	4.5	4.8	4.7	23.4
1985	6.6	2.3	4.5	4.9	5.2	23.5
1986	6.6	1.8	4.2	4.7	5.2	22.5
1987	6.3	2.0	4.1	4.4	5.0	21.8
1988	6.0	1.7	4.1	4.2	5.3	21.3
Five-year averages						
1961-64	4.6	1.0	2.5	5.8	1.9	15.9
1965-69	4.2	1.1	2.9	5.1	1.8	15.1
1970-74	5.3	1.2	4.1	4.9	2.0	17.4
1975-79	5.9	1.8	4.4	4.9	2.5	19.5
1980-84	6.1	2.5	4.2	4.7	4.1	21.7
1985-88	6.4	2.0	4.2	4.6	5.2	22.3

SOURCE Estimates by the Economic Council of Canada based on data from the National Accounts.

Another interesting feature of this table is that the federal government tax mix (of direct and indirect taxes) has evolved in favour of direct taxes. One last observation is worth making from Table 3-4: the increase in federal government revenues is almost completely offset by the increase in federal transfers to the provinces. Thus "net" federal revenues have increased only slightly (approximately 1 per cent) as a proportion of GDP over the last 30 years.

Provincial revenues (again not including local government revenues) are presented in Table 3-5. As with provincial expenditures, provincial tax revenues have been increas-

Table 3-2

Provincial Government Expenditures as a Percentage of GDP, 1961-88

	Transfers to: Individual (1)	Transfers to: Business (2)	Transfers to: Governments (3)	Goods and services (4)	Debt service (5)	Total (6)
			(Per cent)			
1961	1.6	0.1	3.7	2.6	0.4	8.3
1962	1.7	0.1	4.1	2.4	0.4	8.7
1963	1.6	0.1	4.1	2.5	0.4	8.8
1964	1.7	0.1	4.3	2.5	0.5	9.0
1965	1.8	0.2	4.5	2.6	0.5	9.5
1966	1.8	0.2	4.7	2.9	0.5	10.2
1967	2.4	0.2	5.1	3.4	0.6	11.6
1968	2.7	0.2	5.2	3.7	0.6	12.4
1969	2.8	0.2	5.3	3.7	0.8	12.8
1970	2.9	0.2	6.1	4.7	0.9	14.7
1971	3.2	0.3	6.2	4.9	0.9	15.5
1972	3.0	0.3	6.3	4.9	1.0	15.5
1973	2.8	0.4	5.9	4.8	1.1	15.0
1974	2.9	0.5	6.0	5.0	1.0	15.4
1975	3.2	0.6	6.6	5.6	1.1	17.0
1976	3.3	0.6	6.4	5.5	1.2	17.0
1977	3.4	0.7	6.9	5.8	1.2	18.0
1978	3.4	0.6	6.5	5.8	1.4	17.8
1979	3.4	0.8	6.6	5.8	1.4	18.0
1980	3.5	0.8	6.3	6.1	1.6	18.3
1981	3.5	0.8	6.3	6.1	1.7	18.5
1982	3.9	1.0	7.1	6.7	2.1	20.7
1983	4.0	1.2	7.0	6.8	2.2	21.3
1984	3.9	1.1	6.6	6.3	2.4	20.4
1985	3.9	1.1	6.6	6.3	2.5	20.5
1986	4.0	1.2	6.6	6.3	2.6	20.8
1987	4.0	1.0	6.4	6.2	2.6	20.2
1988	3.9	1.0	6.2	6.1	2.5	19.7
Five-year averages						
1961-64	1.6	0.1	4.1	2.5	0.4	8.7
1965-69	2.3	0.2	5.0	3.3	0.6	11.3
1970-74	3.0	0.3	6.1	4.8	1.0	15.2
1975-79	3.3	0.6	6.6	5.7	1.3	17.5
1980-84	3.8	1.0	6.7	6.4	2.0	19.8
1985-88	4.0	1.1	6.4	6.2	2.6	20.3

SOURCE Estimates by the Economic Council of Canada based on data from the National Accounts.

ing at a very rapid rate, comprising 9.9 per cent of GDP during 1960-65 and 20.2 per cent during 1986-90. As with federal revenues, the main component contributing to the provincial increase is personal income tax revenues. Provincial personal income taxes averaged only 0.7 per cent of GDP in the early 1960s, but have increased to 5.2 per cent in the late 1980s. Corporate income taxes have increased gradually from 0.7 per cent in 1960 to 1.0 per cent in 1990. Total indirect taxes (columns 3 and 4) increased from an average of 2.4 per cent during 1960-65 to 3.9 per cent during 1986-90. As is the case with the federal government, the rapid increase in personal income tax revenues

Table 3-3

Consolidated Provincial-Local Government Expenditures as a Percentage of GDP, 1961-88

	Transfers to:			Goods and services	Debt service	Total
	Individual (1)	Business (2)	Governments (3)	(4)	(5)	(6)
			(Per cent)			
1961	1.8	0.2	3.7	8.7	1.0	15.4
1962	1.8	0.2	4.1	8.7	1.0	15.9
1963	1.8	0.2	4.1	9.0	1.0	16.3
1964	1.8	0.2	4.3	9.2	1.1	16.5
1965	1.9	0.2	4.5	9.4	1.1	17.2
1966	2.0	0.3	4.7	9.9	1.1	18.0
1967	2.5	0.2	5.1	10.9	1.2	20.0
1968	2.9	0.2	5.2	11.6	1.3	21.3
1969	3.0	0.3	5.3	12.0	1.4	22.0
1970	3.2	0.3	6.1	13.3	1.6	24.5
1971	3.5	0.4	6.2	13.6	1.7	25.5
1972	3.2	0.4	6.3	13.6	1.7	25.3
1973	3.0	0.5	5.9	13.2	1.8	24.4
1974	3.1	0.6	6.0	13.3	1.6	24.6
1975	3.3	0.7	6.6	14.5	1.7	26.7
1976	3.5	0.7	6.4	14.4	1.8	26.9
1977	3.6	0.8	6.9	14.8	1.9	28.0
1978	3.6	0.7	6.5	14.6	2.1	27.6
1979	3.5	0.9	6.6	14.3	2.1	27.4
1980	3.7	0.9	6.3	14.6	2.2	27.8
1981	3.7	0.9	6.3	14.7	2.4	28.0
1982	4.1	1.1	7.1	15.9	2.8	31.1
1983	4.2	1.3	7.0	16.0	3.0	31.6
1984	4.1	1.2	6.6	15.2	3.1	30.4
1985	4.1	1.3	6.6	15.1	3.3	30.3
1986	4.2	1.4	6.6	15.1	3.3	30.6
1987	4.2	1.1	6.4	14.7	3.3	29.7
1988	4.1	1.1	6.2	14.3	3.1	28.8
Five-year averages						
1961-64	1.8	0.2	4.1	8.9	1.0	16.0
1965-69	2.5	0.3	5.0	10.7	1.2	19.7
1970-74	3.2	0.4	6.1	13.4	1.7	24.8
1975-79	3.5	0.7	6.6	14.5	1.9	27.3
1980-84	4.0	1.1	6.7	15.3	2.7	29.8
1985-88	4.1	1.2	6.4	14.8	3.2	29.9

SOURCE Estimates by the Economic Council of Canada based on data from the National Accounts.

has caused the provincial tax mix to evolve in favour of direct taxes. The fifth column indicates that total transfers from the federal government to the provincial governments have also increased from an average of 2.5 per cent during 1960-65 to 3.9 per cent during 1986-90. However, an important observation with respect to the distribution of power between the federal and provincial levels of government is that the proportion of provincial revenues comprised of transfers from the federal government has decreased. Federal transfers comprised an average of (3.5 per cent/9.9 per cent) = 39.3 per cent of total provincial revenues during the early 1960s to (6.3 per cent/20.2 per cent) = 31.2 per cent

Table 3-4

Federal Government Revenue as a Percentage of GDP, 1960-90

	Personal income tax (1)	Corporate income tax (2)	General sales tax (3)	Other indirect tax (4)	Other revenue (5)	Total revenue (6)
			(Per cent)			
1960	4.9	3.5	2.5	3.3	1.8	16.0
1961	5.0	3.2	2.6	3.3	1.7	15.8
1962	4.5	2.9	2.5	3.4	1.7	15.0
1963	4.5	2.9	2.7	3.1	1.7	14.9
1964	4.9	3.2	3.0	2.9	1.8	15.8
1965	4.6	3.1	3.3	3.0	1.7	15.6
1966	4.7	2.7	3.2	2.9	1.6	15.2
1967	5.3	2.6	3.1	2.8	1.8	15.6
1968	5.7	2.9	2.8	2.6	2.0	16.1
1969	6.7	3.4	2.8	2.5	2.2	17.6
1970	7.2	2.7	2.6	2.4	2.3	17.1
1971	7.4	2.5	2.7	2.5	2.4	17.5
1972	7.7	2.7	2.8	2.4	2.6	18.1
1973	7.2	2.9	2.8	2.2	3.1	18.2
1974	7.7	3.2	2.5	2.0	4.4	19.8
1975	7.4	3.4	2.0	2.1	4.0	18.9
1976	7.5	2.7	2.0	2.1	3.7	17.9
1977	6.2	2.7	2.0	2.0	3.5	16.4
1978	6.1	2.3	2.0	2.0	3.7	16.1
1979	6.5	2.5	1.7	1.8	3.9	16.4
1980	6.9	2.6	1.8	1.7	4.4	17.4
1981	7.1	2.3	1.7	1.6	6.2	18.9
1982	7.3	1.9	1.6	1.4	5.9	18.2
1983	7.2	1.8	1.6	1.5	5.4	17.6
1984	7.0	2.1	1.7	1.5	5.2	17.6
1985	7.3	1.9	2.0	1.6	4.6	17.4
1986	7.8	2.0	2.4	1.8	3.9	17.8
1987	8.6	2.0	2.4	2.0	3.8	18.7
1988	8.0	1.9	2.6	1.8	3.9	18.1
1989	8.4	1.9	2.6	1.9	3.5	18.2
1990	8.9	1.8	2.4	2.2	3.4	18.7
Five-year averages						
1960-65	4.7	3.1	2.8	3.2	1.7	15.5
1966-70	5.9	2.9	2.9	2.6	2.0	16.3
1971-75	7.5	2.9	2.6	2.2	3.3	18.5
1976-80	6.6	2.6	1.9	1.9	3.8	16.8
1981-85	7.2	2.0	1.7	1.5	5.5	17.9
1986-90	8.3	1.9	2.5	1.9	3.7	18.3

SOURCE Estimates by the Economic Council of Canada based on data from Statistics Canada.

during the late 1980s. This represents a potential erosion of federal influence, the implications of which are discussed subsequently.

Table 3-6 focuses on a number of revealing trends in relative expenditure and revenue-raising responsibilities, presenting ratios of federal to provincial levels of activity

Table 3-5

Provincial Government Revenue as a Percentage of GDP, 1960-90

	Personal income tax (1)	Corporate income tax (2)	General sales tax (3)	Other indirect tax (4)	Transfers (5)	Other revenue (6)	Total revenue (7)
				(Per cent)			
1960	0.2	0.7	0.5	1.2	2.5	3.3	8.4
1961	0.2	0.7	0.9	1.2	2.8	3.5	9.2
1962	0.8	0.9	1.2	1.2	2.5	3.4	10.0
1963	0.8	0.9	1.2	1.3	2.3	3.5	10.0
1964	1.0	0.9	1.4	1.3	2.4	3.5	10.5
1965	1.5	0.9	1.4	1.4	2.3	3.7	11.2
1966	1.8	0.8	1.6	1.4	2.4	3.6	11.6
1967	2.1	0.9	1.8	1.4	3.1	3.7	12.9
1968	2.3	0.9	1.9	1.6	3.1	4.1	13.8
1969	2.6	1.0	2.0	1.6	3.3	4.5	15.0
1970	3.1	0.9	2.0	1.6	4.1	4.8	16.4
1971	3.0	0.8	2.1	1.6	4.4	4.8	16.7
1972	3.3	0.9	2.1	1.5	4.2	4.8	16.9
1973	3.4	0.9	2.4	1.4	4.0	4.9	17.0
1974	3.7	1.2	2.4	1.4	4.3	5.3	18.3
1975	3.7	1.2	2.1	1.3	4.6	5.5	18.5
1976	3.9	1.1	2.3	1.2	4.7	5.8	18.9
1977	4.3	1.0	2.3	1.1	4.4	6.4	19.5
1978	4.5	1.1	1.9	1.1	4.4	7.0	20.0
1979	4.2	1.1	2.1	1.0	4.4	7.1	19.9
1980	4.3	1.2	2.0	1.0	4.2	7.0	19.7
1981	4.6	1.0	2.0	1.1	4.1	6.9	19.9
1982	5.1	0.6	2.1	1.3	4.2	7.5	20.7
1983	4.7	0.7	2.2	1.3	4.6	7.2	20.8
1984	4.4	0.8	2.3	1.2	4.5	7.2	20.5
1985	4.6	0.8	2.5	1.2	4.3	7.0	20.4
1986	4.9	0.8	2.6	1.2	4.1	6.3	19.9
1987	5.2	0.9	2.6	1.2	4.1	6.4	20.4
1988	5.2	1.0	2.7	1.2	4.0	6.3	20.4
1989	5.3	1.0	2.8	1.2	3.9	6.2	20.4
1990	5.4	1.0	2.7	1.2	3.5	6.3	20.1
Five-year averages							
1960-65	0.7	0.8	1.1	1.3	2.5	3.5	9.9
1966-70	2.4	0.9	1.9	1.5	3.2	4.1	14.0
1971-75	3.5	1.0	2.2	1.4	4.3	5.1	17.5
1976-80	4.3	1.1	2.1	1.1	4.4	6.7	19.6
1981-85	4.7	0.8	2.2	1.2	4.4	7.2	20.5
1986-90	5.2	1.0	2.7	1.2	3.9	6.3	20.2

SOURCE Estimates by the Economic Council of Canada based on data from Statistics Canada.

(again, provincial activity does not include local activity). Columns 1 and 2 provide data on the expenditure side. The first column shows that the ratio of total federal to total provincial spending has decreased from an average of 1.83 in the early 1960s to 1.10 in the late 1980s, indicating that provincial spending has been increasing at a greater rate than total federal spending. Column 2 presents the same ratio when that part of federal spending that is transferred

Table 3-6

Ratio of Federal to Provincial Levels of Activity, 1961-90

	Spending including transfers (1)	Spending excluding transfers (2)	Goods and services (3)	Revenue excluding transfers (4)	Revenue including transfers (5)	Direct taxes (6)	Indirect taxes (7)
1961	2.03	1.69	2.48	2.46	1.41	9.51	6.17
1962	1.88	1.59	2.53	2.01	1.25	4.39	4.73
1963	1.75	1.49	2.16	1.95	1.26	4.42	4.56
1964	1.66	1.39	2.07	1.95	1.27	4.37	4.07
1965	1.51	1.27	1.89	1.77	1.19	3.24	4.15
1966	1.43	1.19	1.74	1.65	1.10	2.86	3.61
1967	1.32	1.05	1.52	1.58	0.97	2.66	2.99
1968	1.25	1.01	1.40	1.49	0.94	2.70	2.71
1969	1.22	0.97	1.37	1.50	0.95	2.81	2.44
1970	1.13	0.86	1.09	1.39	0.80	2.51	2.33
1971	1.12	0.83	1.05	1.43	0.78	2.56	2.36
1972	1.15	0.89	1.01	1.43	0.83	2.45	2.27
1973	1.14	0.87	0.99	1.39	0.84	2.31	2.02
1974	1.19	0.91	0.95	1.42	0.85	2.21	1.73
1975	1.19	0.92	0.87	1.36	0.77	2.17	1.76
1976	1.12	0.85	0.89	1.26	0.70	2.05	1.62
1977	1.09	0.85	0.89	1.09	0.62	1.67	1.66
1978	1.12	0.87	0.86	1.03	0.59	1.51	1.95
1979	1.05	0.80	0.79	1.06	0.61	1.70	1.57
1980	1.06	0.84	0.74	1.12	0.67	1.73	1.63
1981	1.08	0.86	0.75	1.21	0.75	1.65	1.59
1982	1.10	0.89	0.76	1.10	0.67	1.62	1.37
1983	1.08	0.86	0.71	1.09	0.62	1.66	1.32
1984	1.15	0.93	0.75	1.10	0.64	1.73	1.34
1985	1.15	0.94	0.78	1.08	0.64	1.68	1.39
1986	1.08	0.88	0.74	1.13	0.69	1.72	1.53
1987	1.08	0.88	0.70	1.15	0.71	1.73	1.58
1988	1.08	0.88	0.69	1.11	0.69	1.61	1.52
1989	..	..	..	1.11	0.70	1.63	1.52
1990	..	..	..	1.13	0.76	1.68	1.59
Five-year averages							
1961-64	1.83	1.54	2.31	2.09	1.30	5.67	4.88
1965-69	1.35	1.10	1.58	1.60	1.03	2.85	3.18
1970-74	1.15	0.87	1.02	1.41	0.82	2.41	2.14
1975-79	1.11	0.86	0.86	1.16	0.66	1.82	1.71
1980-84	1.09	0.87	0.74	1.12	0.67	1.68	1.45
1985 on	1.10	0.89	0.73	1.12	0.70	1.67	1.52

NOTE Column 1 – Federal spending including transfers to the provinces/provincial spending.
Column 2 – Federal spending excluding transfers to the provinces/provincial spending.
Column 4 – Federal revenue/provincial revenue excluding transfers.
Column 5 – Federal revenue less transfers/provincial revenue including transfers.
Column 6 – Ratio of personal plus corporate income-tax collections.
Column 7 – Ratio of sales plus excise-tax collections.
.. – Not available.

SOURCE Tables 3-1 to 3-5.

to the provinces is not included as federal spending. In this case, the ratio decreases from an average of 1.54 in the early 1960s to 0.89 in the late 1980s; federal spending has averaged less than 90 per cent of provincial spending during the 1970s and 1980s. The shifting of responsibility towards the provinces is even more pronounced in the case of expenditures on goods and services, as shown in the third column. The latest figures show that federal spending on goods and services is less than 70 per cent of what the provinces spend. Similar trends are present on the revenue side. Column 4 shows that the ratio of own source revenue (transfers not included in provincial revenues) has also decreased, from an average of 2.09 during 1961-64 to 1.12 during 1985-90. Column 5 presents an ad hoc exercise to see what would happen if the federal government had turned over the tax room associated with transfers over to the provinces. In column 5, transfers to provinces are included as provincial revenue instead of federal revenue. The ratio declines from an average 1.30 during the first part of the 1960s to an average of 0.68 during the 1980s. If the provinces had raised the money through their own taxes, provincial revenue would have exceeded federal revenue since 1967. Federal government revenue would currently be approximately 70 per cent of provincial government revenue, and the federal government would have considerably less influence over public expenditures. The last two columns provide data on the relative mix of direct and indirect taxes. The federal government has traditionally been dominant in both the direct (personal and corporate income) and indirect (sales and excise) tax fields, but their dominance has been eroded. Column 6 shows that the ratio of federal to provincial direct taxes has decreased from an average of 5.67 during 1961-64 to 1.67 during 1985-90. Column 7 shows that the ratio of indirect taxes has also been considerably eroded, from an average of 4.88 during 1961-64 to 1.52 during 1985-90. Thus the relative mix of taxes for the two levels of government has remained fairly constant over the years (although the GST may tilt the federal mix towards indirect taxes in the future).

A number of interesting general observations can be made from the data presented in this section. First, the size of total government expenditures has increased dramatically over the last 30 years (from approximately 30 per cent of GDP to 44 per cent of GDP). At the same time, Table 3-6 reveals that government fiscal responsibilities have been considerably decentralized from the federal to the provincial governments, due to the more rapid growth of provincial revenue and expenditure activity. Additionally, the federal government's influence on provincial expenditures, as proxied by the proportion of provincial expenditures resulting from federal transfers, has been considerably eroded. That provincial governments are gradually relying more upon their own sources of revenue may have important implications for the ability of the federal government to achieve national objectives, as discussed later on.

Constitutional Changes and Interpretations

The existing constitutional arrangements and their interpretation may well become *passé* in the not-too-distant future. Nonetheless, from an economics point of view, it is worth recounting some of the events of the recent past since some of them do have economic implications. The most significant changes occurred with the constitutional amendments contained in the Constitution Act of 1982. Before discussing these in detail, it is worth summarizing the key features of the underlying constitution which are of relevance for federal-provincial fiscal relations.

The economic responsibilities of the federal and provincial levels of government are set out in the British North America (BNA) Act of 1867. Section 92 provides provincial legislatures with the exclusive right to make laws in various areas including matters of a local or private nature within the province, property and civil rights, hospitals, management and sale of public lands, and the administration of justice. As well, they are given the right to use direct taxation to raise revenue for provincial purposes and, significantly, the control of municipal institutions. Section 93 gives the provinces exclusive jurisdiction in the area of education, while Section 95 gives joint responsibility in the areas of agriculture and immigration, with federal laws assuming predominance in the case of conflict.

The main federal responsibilities are set out in Section 91. They include in the preamble rather general powers to make laws for the "peace, order and good government of Canada" (the so-called POGG clause) as well as any areas not explicitly allocated to the provinces (the residual power). In addition, the federal government is assigned explicit responsibility in such matters as the public debt and property, regulation of trade and commerce, defence, money and banking, and the criminal law. Significantly, they are allowed to raise money by any type of taxation. Furthermore, Section 106 gives the federal government the right to appropriate funds from the Consolidated Revenue Fund for the "public service." This provision has been used in part to justify the use of the spending power to which we return later on.

As has been fully documented by Hogg [1985], it seems clear that the intent of the design of the BNA Act was to provide for a strong and fiscally dominant federal government, though one in which many services were to be delivered at the provincial (or municipal) level. Changing economic circumstances over time, however, have resulted in a changing balance between the two principal levels of government. The Act granted essentially unlimited taxing powers to the federal government; whereas the provinces were to be restricted to direct taxes. Since, at that time, direct taxes such as the personal income tax were largely unused, the principal source of government revenue being through various excises and duties, especially customs duties, this severely limited the revenue-generating capacity of the provinces. Over the years, there has been an increasing trend to the utilization of direct rather than indirect taxes, and this has strengthened the position of the provinces. In addition, the provinces have not been precluded by the constitution from enacting sales taxes, even though to an economist these might be deemed to be indirect. Furthermore, an important restriction on the federal government was that it could not tax provincial lands or property. Not the least in this regard has been the role of provincially owned natural resource revenues, especially oil and gas revenues, which have augmented the tax capacity of some provinces and in the process have severely strained federal-provincial fiscal relations. All of these have strengthened the position of the provinces relative to the federal government. At the same time, the areas of provincial expenditure responsibility, especially health, education, and welfare, have grown very rapidly and continue to do so. Yet, the federal government has, at times, been able to exercise immense influence over the provinces through the use of its spending power in these areas. Thus, despite the intentions of the constitution, the provinces have evolved to be comparable in economic powers to the federal government. The data presented earlier attest to that.

The BNA Act could be amended by an Act of the British Parliament, in practice on the advice of the Canadian government. Prior to the Constitution Act of 1982, there had been two amendments, both of which significantly affected the balance of economic responsibilities between the two levels of government. These involved unemployment insurance and pensions which the provinces were generally regarded as having legislative responsibility for by the property and civil rights provision of Section 92. The unemployment insurance amendment was initiated as a consequence of the federal government attempting to implement a scheme in 1937. Ontario objected and took the case to court on constitutional grounds, arguing that the federal Act constituted legislation in an area of exclusive provincial jurisdiction. The federal scheme had actually imposed its own duties (premiums) on employers and employees. The Privy Council had refused to isolate the spending side of the scheme and upheld that part under the spending power.[1] By the Constitution Act of 1940, a constitutional amendment was passed with the support of seven (of nine) provinces which added unemployment insurance to the list of exclusive federal powers (Section 91(2A)).

The pension case was influenced by the unemployment insurance reference. In 1950, the federal government had the unanimous support of the provinces for the Old Age Security scheme. However, based on the unemployment insurance reference, the Supreme Courts of Nova Scotia and Canada ruled that it was unconstitutional for the provinces to so delegate authority to the federal government. The federal government, with the unanimous support of the provinces, had the U.K. Parliament enact an amendment in 1951 giving the federal government authority to make laws in relation to old age pensions (Section 94A). The section was further modified in 1964 to include supplementary benefits, including survivors and disability benefits irrespective of age. The Canada Pension Plan was subsequently introduced in 1965. Section 94A has assumed special interest in the contemporary debate about the constitution since it allows for concurrent federal and provincial legislative authority subject to provincial paramountcy, should a province elect to invoke it. Concurrency with provincial paramountcy has formed a significant part of the constitutional proposals of Milne [1991] and Courchene [1991].

The Constitution Act of 1982 is popularly known as the instrument that repatriated the Canadian constitution, albeit without the consent of the Quebec legislature. However, it also contained several provisions with potentially important implications for federal-provincial fiscal relations, of which three are particularly relevant. They are the institution of the *Charter of Rights and Freedoms* (Part I, Sections 1-29), the spelling out of federal responsibilities in the areas of equalization and regional disparities (Part III, Section 36), and the devolution to the provinces of authority and taxing power over nonrenewable resources (Section 92A).

The *Charter of Rights and Freedoms* contains at least two sections which are of potential relevance for fiscal federalism – the Mobility Rights provision (Section 6) and the Equality Rights provision (Section 15). The Mobility Rights section provides for the freedom to move among provinces and to pursue a livelihood in any province. In other words, it guarantees the unrestricted movement of labour (subject to the qualification that it may be violated if regional unemployment rates are above the national average). What is missing in the constitution is the analog for goods, services, and capital – i.e., there is little explicit guarantee of maintenance of the economic union in the Canadian federation, perhaps with the consequence that there exist many interprovincial barriers to the free flow of goods and factors. The Equality Rights section guarantees equality before the law without discrimination. The implication of each of these for economic policy has yet to be determined by the courts, but potentially they are important. For example, the equality provision may help define national equity standards, and the mobility provision may restrict provinces in applying discriminatory labour policies.

The nonrenewable resource section essentially devolved to the provinces the power to regulate and to tax in any manner natural resources within provincial boundaries. In a sense, it simply recognized what had come to be the practice at the time. It is relevant for our discussion because it is undoubtedly one aspect of the federation which is immutable – i.e., the provincial ownership and control of resources. One can certainly make strong economic arguments for the centralization of resources, and many federations are organized in this way. However, it is sensible to take provincial ownership of resources as an historical given in our discussion.

Section 36 under the title "Equalization and Regional Disparities," contains two parts. It is worth reporting them in full since they have an important bearing on our subsequent discussion. They read as follows:

> 1 Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the Government of Canada and the provincial governments, are committed to
>
> a) promoting equal opportunities for the well-being of Canadians;
>
> b) furthering economic development to reduce disparity in opportunities; and
>
> c) providing essential public services of reasonable quality to all Canadians.
>
> 2 Parliament and the Government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

In effect, these provisions would seem to have two potential sorts of effects on federal responsibilities and obligations. The first part explicitly recognizes the pursuit of equity as a national objective, though an objective whose responsibility is shared with the provinces. This is important since, as discussed further later on, much of what governments do, including the provincial governments, has a significant equity dimension. Thus it might be thought of as a justification for federal involvement in provincial programs through the spending power. The second part imposes an obligation of a specific sort for the federal government to pursue equalization objectives. The wording of the provision if taken literally would have serious implications not only for the formal Equalization scheme itself, but also for other major federal-provincial transfers as well.

An important component of federal-provincial fiscal arrangements has been the use of conditional grants by the federal government. Despite the fact that the BNA Act gives the provinces "exclusive" legislative responsibility in the areas of health, education, and welfare, the federal government has from time to time used conditional grants to provide an incentive for the provinces to implement programs satisfying specific federal criteria. This is referred to as the use of the federal "spending power." The constitutionality of such measures has been an issue in the past. However, the federal government has usually been successful in arguing their case.

The legal basis for the spending power in the BNA Act of 1867 is justified on the following grounds.[2] First, by Section 91(3), the federal government has the power to levy all types of taxes. By Section 91(1A), the federal government is entitled to legislate in relation to public property. By Section 106, the federal government can use its revenue for matters deemed to be in the "public service." Furthermore, the POGG clause gives a more general justification for spending measures which are meant to be in the national interest. Finally, since the spending power leaves the ultimate legislative responsibility for the program in question to the provinces, its use can be deemed not to interfere with Section 92, which gives the provinces exclusive legislative responsibility for certain areas. The provision of financial incentives through the spending power is assumed not to interfere with the ultimate provincial legislative power as long as the federal government does not directly engage in program provision. In other words, there is a distinction between compulsory regulation as opposed to spending which imposes only voluntary obligations. A statute which does no more than spend money is authorized by Section 91(1A) even if the spending power purposes are outside the regulatory powers of the federal government. Imposing conditions whatever their incentive effect might be is not the same as exercising legislative authority.

A number of constitutional court cases have borne this interpretation out. Some examples are as follows.

Central Mortgage and Housing Corp. v. Co-Operative College Residences (1975) 13 O.R. (2d) 394 (Ont. C.A.) — Though housing is within provincial legislative responsibility, the courts held that the federal government could lend funds conditional on the funds being used only for student housing. As the court said:

> The loaning of public money to aid university student housing is simply one way of imposing conditions on the disbursing of federal public funds. It is a proper exercise of the power of the Parliament of Canada under Section 91(1A). The true nature and character of the legislation is the disbursement of public funds.

Winterhaven Stables Ltd. v. A.-G. Can. (1986) (Alta. Q.B.) — In this case, the court ruled that the use of federal income tax revenues for the purposes of financing grants to the provinces in aid of health care and postsecondary education (under Established Programs Financing [EPF]) was constitutional. The judgment said:

> [Parliament] can impose conditions on such disposition so long as the conditions do not amount in fact to a regulation or control of a matter outside federal authority. The federal contributions are now made in a way that they do not control or regulate provincial use of them.

Further on, it said: "While the federal legislation does influence and affect matters under provincial jurisdiction they are, in my view, laws dealing with the proper disbursement of federal public funds."

Dunbar v. A.-G. Sask. (1984), 11 D.L.R. (4th) 374 (Sask. Q.B.) — This case dealt with provincial conditional grants for international aid and in a sense tested the provincial use of its spending power. The court said: ". . . it is almost impossible to envisage a grant, voluntarily accepted, imposing conditions that would be synonymous with regulation. . . ."

A.-G. Can. v. A.-G. Ont. (Unemployment Insurance) (1937) A.C. 355 — As mentioned, the federal unemployment insurance scheme was struck down because it went *beyond* the spending power by establishing contributions involving duties (premiums), and therefore affected "civil rights of employers and employees in each province, and as such is invalid."

Recent constitutional revisions could be taken to support and even strengthen this use of the spending power. As mentioned, Section 36(1) of the Constitution Act of 1982 explicitly recognizes the shared federal-provincial responsibility for equity. It can be argued on economic grounds that virtually all major shared-cost programs in the areas of health, education, and welfare have redistributive equity as their ultimate rationale – i.e., if efficiency were the sole criterion, there would be no need for public-sector intervention in health, education, or welfare at all. Thus the federal government can now argue that they have an interest in the equitable provision of these services, and since they are precluded from providing them directly, the spending power is the only instrument available for discharging their equity responsibilities. A similar argument might be made with regard to Section 36(2). It could be said that the equalization responsibility is fulfilled jointly by the formal Equalization scheme along with the other major transfer schemes discussed later (EPF and the Canada Assistance Plan [CAP]). Each of these has an equalizing component, and they complement each other.[3]

The proposed constitutional amendments of the ill-fated Meech Lake Accord included a provision which would have made the use of the spending power for national objectives indisputable. Section 106A stated:

> 1 The Government of Canada shall provide reasonable compensation to the government of a province that chooses not to participate in a national shared-cost program that is established by the Government of Canada after the coming into force of this section in an area of exclusive provincial jurisdiction, if the province carries on a program or initiative that is compatible with the national objectives.
>
> 2 Nothing in this section extends the legislative powers of the Parliament of Canada or of the legislatures of the provinces.

Part 1 essentially implies spending power; and Part 2, therefore, implies that federal spending power in areas of exclusive provincial jurisdiction has always existed.

Because of the opting-out provision, this section was viewed by some as a potential threat to future federal-provincial cost-sharing initiatives. The use of the federal spending power in shaping the development and design of various social programs has been crucial. Some argued, however, that the opting-out provisions of the Accord would have rendered the federal government less likely to take such initiatives in the future. Others argued that the effectiveness of the spending power would not have diminished with opting out because to opt out, a province would have to maintain a program with national standards. Furthermore, the financial compensation for opting out would implicitly include the same financial incentives as for the provinces which choose not to opt out. As it turned out, the matter became academic with the defeat of the Accord in June 1990. However, the debate may have some relevance for evaluating future constitutional initiatives.[4]

Recent Federal Policy Initiatives

From the previous discussion, it seems clear that the existing constitution is flexible enough to allow for varying degrees of centralization or decentralization of economic power. For example, the federal government could exercise potentially significant amounts of financial control through its vast taxing and spending power. However, except for the commitments in Section 36 of the Constitution Act of 1982, they may also choose to decentralize responsibilities to the provinces. Thus the respective federal and provincial financial responsibilities are to a large extent a matter of actual policy decisions. In this section, we outline a number of recent policy initiatives which have a bearing on the relative exercise of federal and provincial economic power. In discussing these policy initiatives, there are two notions of decentralization that should be borne in mind. On the one hand, decentralization may refer primarily to the provinces having greater importance from a financial point of view. That includes a relative reduction in transfers from the federal government to the provinces and an increase in the relative importance of the provinces in the various tax fields. This financial decentralization is the primary focus of this paper. On the other hand, the power of decision making may be decentralized to the provinces in ways which involve little change in the fiscal structure. For example, regulatory functions may be decentralized with little financial effect.

Deficit Reduction Measures

A high priority of recent budgets has been the focus on reducing the size of the deficit and ultimately the stock of debt. There are a variety of combinations of ways of doing this on the expenditure and the tax sides of the budget. In the two most recent federal budgets (1990 and 1991), the government has put a substantial part of the burden on the expenditure reduction side. At the same time, it has taken the position that the part of the budget consisting of transfers to individuals should be protected. That leaves only transfers to governments and business, and expenditures on goods and services as instruments for deficit reduction. Of these, the bulk of the burden was put on transfers to the provinces, both limits on EPF transfers for all provinces and limits on CAP transfers for the three have provinces.

In evaluating this stance, a number of points can be made. First, from an economics point of view, transfers to individuals are like negative direct taxes, so there is a certain logic to treating both symmetrically from a policy point of view. Reducing transfers to individuals is equivalent to increasing taxes, and it has been decided not to rely heavily on that for deficit reduction.

However, the same logic would also seem almost to apply to the case of transfers to the provinces. Passing on the burden of federal deficit reduction to the provinces by reduced transfers is also equivalent to increasing taxes to the extent that the provinces must make up their lost revenue from their own source taxes. The only difference is that the tax revenue is at the provincial level rather than the federal level. Of course, there is the possibility that the provinces have more scope for reducing expenditures than the federal government does. To the extent that expenditure reduction is the objective, the net outcome may be partly successful.

Apart from this apparent logical inconsistency in deciding against tax increases while forcing them upon the provinces, the use of transfers to the provinces for deficit reduction purposes has longer term effects on the structure of federal-provincial fiscal relations.[5] In particular, there are two consequences that flow from it. The first is that the reduction in federal-provincial transfers and the resultant increase in provincial tax requirements shift the balance in taxing power from the federal to the provincial governments. Furthermore, this shift may be largely irreversible. As we discuss later, the ability of the federal government to take a lead in maintaining a system of harmonized direct taxes across the two levels of government depends upon the share of the tax room it occupies. As the provinces occupy a larger and larger share of the income tax room, the pressures for fragmenting the system increase. The advantages of a harmonized income tax system are discussed further in a later section. Basically, tax harmonization reduces the compliance and enforcement costs of the system for both the private sector and the government, increases the efficiency of resource allocation within the federation, and facilitates the achievement of national equity objectives by the federal government. Second, the reduction in federal-provincial transfers reduces the ability of the federal government to achieve national objectives through the use of the spending power. As long as the EPF grant is financed by a combination of tax point transfers and cash transfers as in the current system, reductions in the cash transfer are bound to cause it to disappear as a component, leaving the federal government with little spending power clout.

Introduction of the Goods and Services Tax

The GST was introduced for reasons which had little to do with federal-provincial fiscal relations. In fact, there is no evidence that the impact of the GST on federal-provincial fiscal relations was a policy consideration in the decision to implement it. Most economists would agree that, as an indirect tax system, the GST is reasonably well conceived. However, from a federal-provincial fiscal relations perspective, the GST has some drawbacks. The main one is that, if the evidence from other countries is anything to go by, it is likely that the direct-indirect tax mix of the federal government will gradually change in favour of the indirect. The implication of this is that the federal government will likely reduce its occupancy of the income tax fields in favour of the provinces. As argued in Boadway [1990], this could put strains on the system of income tax harmonization and reduce the ability of the federal government to achieve its national equity goals.

There is a further drawback to the GST and that concerns harmonization with the provinces. A fully harmonized GST involving the federal government and the provinces will be very difficult to achieve. It is simply too difficult to operate a multistage tax in a multijurisdictional system of government. Almost all countries that have a value-added tax operate it from the centre (an exception being Brazil). The problem is that the system of crediting becomes difficult to administer when intermediate sales go through more than one jurisdiction. Perhaps the best that can be done is to have the provinces retain a single-stage system, with that stage being harmonized as closely as possible with the GST.

The above problems could have been avoided had the federal government chosen to adopt the advice of the Carter Commission some 25 years ago. That advice was for the federal government to vacate the indirect tax field altogether and allow the provinces to be the sole occupant. The federal government would then be relatively more important in the direct tax field than otherwise. This would accord with the traditional assignment of tax bases in a federation that is found in the textbooks.[6] The indirect taxes, presumably, would not be harmonized among the provinces, and a multistage tax would not be used. Indeed, as long as the provinces operate general sales taxes, a value-added tax is not an attractive option. However, the argument is that if the choice is between having a harmonized direct tax and a harmonized indirect tax, the former is the preferable alternative.

The Operation of the Tax Collection Agreements

The basic form of the Tax Collection Agreements have been in operation continuously since 1962. The only major change occurred in 1972 when the federal government began allowing the provinces to introduce tax credits to be administered by the federal government. To be admissible, these credits were supposed to satisfy three criteria. They had to be administratively feasible; they must not erode the essential harmony and uniformity of the tax system; and they must not jeopardize the functioning of the Canadian economic union. At the time the Tax Collection Agreements were first entered into, the federal government was dominant in the income tax fields. As the provinces have become more and more important users of income tax, the system has come under increasing strain. The signs of the strain are several. One province (Alberta) has withdrawn from the corporate Tax Collection Agreements. Others have studied the option seriously (Ontario in the case of the personal income tax and British Columbia for the corporate tax), and have so far declined to take action despite voicing dissatisfaction with the absence of ability of the provinces to pursue independent tax policies. The incidence of tax credits has increased rapidly both at the personal and corporate levels. Some of these credits seem clearly to affect the allocation of capital across provinces, such as venture capital and stock savings programs and various tax credits under the corporate income tax. The principle of a common base has even been eroded as Alberta, Manitoba, and Saskatchewan received permission to introduce flat taxes on bases different than federal taxable income (i.e., net income).

The tension seems to have arisen because of the fact that the federal government retains unilateral control over both the base and rate structures of the income taxes. This leaves open to the provinces only the ability to choose the level of rates and the use of credits for provincial policy purposes. As the provinces become more and more important in the income tax fields, these tensions are bound to increase. Studies for the provinces of Ontario and British Columbia have recommended that the provinces be given a greater role in any changes that involve the base and rate structures [see Boadway, Cromb, and Kitchen 1989; and Clarkson Gordon 1988]. Both recognize that the system of Tax Collection Agreements has served the federation very well. Indeed, the Canadian system has been cited as a model for the policy discussions on tax harmonization in the European Economic Community.

Structural Changes in Established Programs Financing and Equalization

The structures of both the EPF and Equalization systems have undergone some significant changes in the past several years which have influenced their effectiveness as transfers. In the case of the EPF, the major structural change resulted from the Canada Health Act of 1984. This Act reaffirmed the requirement that to be eligible for the full amount of the EPF cash transfer in support of health expenditures, a province had to maintain a publicly administered health-insurance system which was comprehensive, accessible, universal, and portable. However, it also introduced penalties for provinces whose health-care systems engaged in extra-billing and user charges. The penalty was a dollar-for-dollar reduction in transfer for moneys raised through these practices. The establishment of financial penalties for failing to meet federal conditions was not new. Prior to the Canada Health Act, the federal government could penalize provinces whose health-care systems did not satisfy the above criteria. This provision was never used, and it was regarded as being a rather blunt instrument.

The imposition of conditions with penalties on provincial health-care systems has been a matter of some controversy. Those who oppose it argue that the provision of health services is clearly a provincial responsibility, and that the full decentralization of health care is likely to lead to more efficient provision through interprovincial competitive pressures. Those who argue in favour of the use of the spending power in the health-care area do so on the grounds that health care is fundamentally an instrument for the pursuit of equity, and the use of the spending power is the only means by which the federal government can achieve national standards of equity in health care. Clearly, the matter goes beyond pure economic argument and requires making a value judgment about equity versus efficiency. It is not surprising that economists disagree on the matter. It does seem quite clear, however, that from a constitutional point of view, the use of the spending power in this way can be supported.[7]

The periodic reductions in EPF cash transfers through budgetary measures will make it more difficult for the federal government to maintain effective national standards in health care. Since the inception of EPF in 1977, there have been a number of instances in which the size of the transfers has been reduced, and these have all been felt on the cash-transfer side. In 1982, there was a reduction of the equivalent of two personal tax points which had originally been used to compensate for the so-called revenue guarantee in the 1972 tax reform. This may or may not have been justifiable in terms of the revenue guarantee itself, but one result was a reduction in the size of the cash transfer. In 1984 and 1985, the notional postsecondary education component was restricted to increases of 5 and 6 per cent respectively as part of the anti-inflation policy of the time. (This component is notional only since there are no restrictions on its use.) In 1986, the growth of EPF transfers was reduced from the rate of growth of GNP to that rate less 2 percentage points. Then, in the budgets of 1990 and 1991, the per-capita amount of EPF transfers was frozen.[8] The consequence of these reductions is that the cash component of EPF is becoming less and less important relative to the tax-transfer component and is likely to disappear altogether in the near future. It could be argued that, once the federal government eliminates cash transfers and requires the provinces to increase their tax room, it will be difficult to reverse the process. While the federal government has stated that it will find other ways to penalize the provinces who fail to meet the full criteria set out in the Canada Health Act, it is not at all clear how this can be done. The other major grant schemes (Equalization and CAP) are negotiated separately with their own objectives in mind; and Equalization applies only to some provinces.

The Equalization system itself has undergone some fundamental revisions. Prior to 1982, the system used the so-called national-average standard for determining equalization payments to the have-not provinces – i.e., the entitlement was calculated to bring the tax capacity of the have-not provinces up to that of the national average. It is true that oil and gas revenues were not fully equalized. However, as the Economic Council of Canada [1982] argued, given the provincial property rights over natural resources, this was not an unreasonable situation. In 1982, the formula was changed in several significant ways, jointly designed to reduce the financial commitment of the federal government and to ensure that Ontario did not become a have-not province. The main measure was to change from a national-average standard to a five-province standard (Ontario, Quebec, Manitoba, Saskatchewan, and British Columbia). Although oil and gas revenues were included fully in the formula, since Alberta was not part of the standard, oil and gas revenues were, in effect, largely unequalized. Also, in 1987, the rate of growth of the total Equalization transfers was capped at the cumulative rate of growth of GNP.

International Developments

Changes in the international climate facing the Canadian economy may influence the development of fiscal relations within the federation. In particular, they may increase the constraints faced by policymakers. For example, the growing internationalization of capital markets constrains the ability of governments, both federal and provincial, to impose taxes on capital income. With highly open capital markets, rates of return on capital are largely predetermined internationally. The only independence that may exist domestically arises from country-specific risk, including that arising from government policy itself, or imperfect capital markets. For example, small businesses may to some extent operate on segmented capital markets. However, by and large, international rates of return are exogenous. This implies that the ability to extract taxes from capital income is severely limited. In an economy such as Canada's, the taxation of corporate income is to a considerable extent dictated by foreign tax crediting arrangements in creditor countries, especially the United States[9] – i.e., one of the main roles of the corporate tax has become to facilitate a tax transfer from foreign treasuries to Canada by exploiting the ability of foreign corporations to obtain credits for taxes paid in Canada. This implies that our corporate tax structure is constrained to be similar to that in the United States. Any attempt to try to extract more taxes from corporate capital than that will be futile. Because rates of return are fixed, the tax liabilities will simply be shifted back to noncapital factors of production in Canada, especially labour. At the same time, attempts to increase investment through tax incentives will partly result in a tax transfer to foreign treasuries.

At the same time, because of the system of tax harmonization that exists in Canada, there is an incentive for provinces to engage in tax competition. Under the tax crediting system which operates internationally, there is little gain to provinces from trying to attract capital from abroad via corporate tax incentives for the reason mentioned before. The incentive will simply reduce the size of the transfer from foreign treasuries without affecting the incentive to invest. However, with the allocation formula used for provincial tax collections, provinces can succeed in attracting capital from neighbouring provinces by offering more attractive tax treatment. The total amount of provincial taxes that domestic firms are liable for depends upon which provinces their profits are earned in. If a province lowers its tax rate (or provides an investment incentive), it will provide an incentive for domestic firms to relocate their activities in the low-tax province, but should not affect foreign firms because of the crediting arrangement. This means that there is an incentive for provinces to engage in interprovincial beggar-thy-neighbour policies, even though such an incentive does not exist at the federal level. This observation has implications for the ideal assignment of taxes and is discussed further later on.

Federal Energy Policies

In addition to the changes in the treatment of oil and gas under the Equalization system, the federal government has disengaged itself from the energy field over the 1980s. We have already discussed the constitutional changes of 1982 which eliminated restrictions on provincial policies in the resource field. The federal government has also effectively turned over to the provinces a large amount of financial responsibility with the dismantling of the National Energy Policy (NEP) and the signing of bilateral agreements on oil and gas with the western provinces, Nova Scotia, and Newfoundland. Thus the federal government no longer has a major resource tax with the elimination of the production taxes of the NEP. As well, the various bilateral accords have basically turned over to the provinces the rights to the resource revenues within provinces as well as offshore. At the same time, there has been a disengagement of the federal government from the expenditure side with the elimination of large grant programs such as the Petroleum Incentive Payments.

The implication of these various changes discussed in this chapter is a federation which is considerably more decentralized than in the immediate postwar period. Provincial expenditure responsibilities have grown rapidly over the period, especially in the areas of health, education, and welfare. The federal government has maintained financial responsibilities larger than their own expenditure responsibilities through a system of federal-provincial grants. This has enabled them to keep a dominant position on the direct tax field and to use grants largely for redistributive purposes. However, recent developments are accelerating the decentralization of the federal finances, and it is not clear that the system of tax and expenditure harmonization that has evolved over the period can be sustained much longer.

4 Efficiency in a Federal Economy

The overall purpose of this study is to evaluate arguments for the division of powers between the federal and provincial levels of government from a purely economic point of view. This involves judging how well resources are allocated in the economy under various institutional organizations of government. From a welfare economics perspective, resource allocations should ultimately be compared using some notion of a *social welfare function*. It is useful conceptually to disaggregate the social welfare evaluation into an efficiency and an equity component. This is a rather fictitious procedure since almost all policies involve both components and one must be traded off against the other. Nonetheless, it is a useful heuristic device for our purposes.

The role of government hinges on the equity and efficiency contributions that the government can make to an otherwise decentralized market economy. Special problems of efficiency and equity arise in a federal state over and above those of a unitary state, and these have a particular bearing on the division of powers. In this chapter, we consider the problems of efficiency in a federal economy. The next chapter discusses equity in the same setting.

As in a unitary state, efficiency and equity objectives will often conflict in a federal economy. Furthermore, the two objectives will generally call for differing degrees of decentralization. In particular, equity considerations probably call for a greater degree of centralization of government responsibilities than efficiency considerations do. This is worth stressing because much of the debate about centralization versus decentralization among economists hinges essentially on different weights put on efficiency versus equity. Much of the recent literature that has argued in favour of a more decentralized federation ultimately rests on purely efficiency arguments. The notion is that a decentralized government is likely to be leaner and more efficient, and to respond better to local preferences than a centralized government.[1] This is due to the fact that a decentralized government is "closer" to the people, and due to the competitive pressures that lower levels of government feel because of the mobility of goods and factors. More generally, those who prefer a decentralized government may simply want more autonomy of local governments to pursue their own objectives in as responsive and innovative a way as possible without being constrained by the central government. A good summary of the arguments may be found in Breton [1990].

By the same token, those who call for more centralization ultimately rely on economic arguments which have equity as their base. Thus the economic issue of the division of powers is ultimately bound up with value judgments about the relative weight of equity versus efficiency considerations. The trade-off is often only implicit – i.e., much of the economic analysis, here as elsewhere, implicitly takes efficiency as the proper objective of economic policy. Our purpose here is not to question judgments that persons make in this regard; instead, it is to make explicit the importance of making that judgment.

The meaning of efficiency in a unitary state is well known and understood. A fully efficient economy is one in which all possible gains from trade have been exploited. In an economy consisting of only private goods, the conditions for efficiency can be summarized in the *exchange efficiency*, the *production efficiency*, and the *overall efficiency* conditions. The decentralized competitive market mechanism ensures that these conditions are satisfied under certain assumptions. Furthermore, decentralization leads not only to these "economic" efficiency conditions being satisfied, but also encourages technical efficiency so that resources are not wasted in production. The efficiency role for government reduces to correcting for market failures – i.e., to intervening in circumstances in which the market fails to exploit fully all gains from trade. We have discussed earlier the sources of market failure and the role the government has in correcting them.

In a federal economy with several distinct political jurisdictions, a number of additional efficiency considerations arise. We discuss five important ones.

The Internal Common Market

The maintenance of the internal common market (or *economic union*) is a requirement for an efficient federal economy. It involves maintaining the free flow of goods, services, labour, and capital across all internal boundaries. In a unitary state, there are no internal boundaries to worry about, so it is not an issue. However, in a federal state with some decentralization of powers, provincial decision making can impede the flow of transactions across borders. The absence of barriers to interprovincial flows is a necessary condition for the efficiency conditions (production, exchange, and overall) to apply within the federal economy – i.e., for all marginal rates of substitution to equal the appropriate marginal rate of transformation. It is widely accepted to be a desirable objective for a federal economy.

From a purely theoretical point of view, the maintenance of a nondistorted internal common market may or may not be the most efficient outcome. Suppose, for example, that the economy maintains some trade distortions with the rest of the world by tariffs and the like. The theory of second best suggests that in these circumstances, it is not necessarily optimal to remove all internal distortions. Much of the economic theory of customs unions has focused on the second-best efficiency properties of removing trade distortions among political jurisdictions when such distortions exist with outsiders. Unfortunately, the design of a truly second-best policy for the internal common market is a virtually impossible task, especially when one takes account of possible dynamic gains from opening up internal markets. Therefore, despite the lack of a supporting theory, the maintenance of the internal common market is taken to be a practically desirable objective. In a second-best setting, deviations from the internal common market are as likely to move in a detrimental direction as a beneficial direction. Since the welfare costs of such deviations increase roughly with the square of the size of the distortion, the loss from moving in the incorrect direction exceeds the gain in moving in the correct direction. Therefore, the expected level of social welfare will be higher in the no-distortion situation than in the situation in which distortions are imposed if it is not known whether the distortions are in the right direction or not. Of course, it can be argued that the trade diverting effects of the Canadian federation are sizable. Since natural trade flows seem to be north-south, the artificial inducement of east-west trade within Canada may reduce welfare. This must be set alongside the benefits of free flows of labour and capital mentioned later.

There are many potential ways in which the actions of the lower levels of government can interfere with the efficiency of the internal common market. The most obvious is by the imposition of taxes of various sorts. Of course, taxes by their very nature must necessarily cause distortions, even in a unitary state. In a federal state, the issue is whether they also distort interprovincial flows of various sorts. Differential provincial sales tax rates can interfere with the free flow of goods and services across borders. In principle, if sales taxes are levied on a destination basis, goods and services trade should not be affected. Residents of a given province should face the same set of sales taxes no matter where they buy their goods and services. The only distortion the sales tax would cause across boundaries would be the incentive to reside in one province rather than another. In practice, however, the strict application of the residence principle is impossible within a federation because of the absence of border controls. Cross-border shopping is difficult to monitor. Thus some distortion of goods and services flows is inevitable.

The magnitude of distortions imposed by indirect sales taxes on goods and services is likely to be less than the distortions imposed by direct taxes on factor markets, both labour and capital. Direct taxes on households in the form of personal income taxes or payroll taxes can, like indirect taxes, impose an incentive for locating in one province over another. However, due to the progressive nature of the tax, the incentive might be much more for higher income persons. These are also the most mobile ones. As well, taxes on capital income at source, such as the corporate income tax, can distort the pattern of capital flows across the provinces. Given that capital is presumably much more mobile than labour, the efficiency cost of capital market distortions is likely to be much higher than for labour markets. Capital market tax distortions can also come about through provisions of the personal tax system. For example, tax incentives to use personal savings to acquire local equity can serve to fragment capital markets, though it may also simply serve to subsidize local saving since the increase in acquisition of local assets may largely crowd out nonresident capital inflows. The transfer system has analogous effects on labour markets, though in an opposite direction. Low-income persons will have an incentive to locate where the transfer system is the most generous.

Given this, there may be pressures for provinces not to impose differential tax and transfer rates – i.e., competitive pressures across jurisdictions may force uniformity. These pressures will be greater the more mobile are resources across jurisdictions. The pressures for, and the gains from, uniformity of tax and transfer systems across jurisdictions will be discussed further later. However, not all provinces will be able to levy exactly the same level of tax rates because the relative size of their tax bases will differ. Thus there will necessarily be differences in tax rates (or service levels) across provinces in a decentralized federation. This is the problem of fiscal efficiency and is discussed further subsequently.

Interprovincial distortions may also arise from differences in the expenditure side of provincial budgets. If the levels of service are different for particular sorts of persons, this will give rise to incentives to migrate. Some provisions of expenditure programs may actively inhibit migration. An example of this would be the absence of portability provisions in public services and pensions. Again, interprovincial competitive pressures may induce some uniformity of provision of services. However, the level of provision thus induced may not be optimal. This is discussed further later.

Another source of interprovincial distortions is the use of preferential procurement practices by provincial governments in purchasing inputs for the public service. The effect of this is to distort the use of resources away from their most efficient use. If all provinces engage in it, the net outcome is a reduction in opportunities for mutual gains from using the least-cost inputs in the public sectors.

Finally, the regulatory function of governments may interfere with the free flow of trade across borders. This can occur both on markets for goods and services and on factor markets. Regulating the supplies of agricultural markets, communications, energy, transportation, and the like can all impede interprovincial trade and reduce the efficiency of the common market. Regulating various aspects of the labour market such as the professions and the trades can reduce the hiring of labour across borders. Similarly, on capital markets, regulating of financial institutions at the provincial level could potentially lead to some segmentation of capital markets. In some sense, almost any regulatory function performed by provincial governments is bound to lead to some interference with the smooth functioning of the economic union. Unfortunately, it is very difficult to estimate the size of the distortions imposed by regulation.

Central governments are, of course, not immune to implementing policies which interfere with the internal common market. Policies which are intended to address regional development issues can have this effect. Other federal policies can have incidentally discriminating effects across regions even though they are applied according to uniform rules across the country. Unemployment insurance is an example of this, although even it has had explicitly discriminatory provisions from time to time. Federal expenditure policies applied selectively to certain regions may also lead to inefficiencies. Examples include military base siting and government contracting. Unlike with provincial governments, there are no offsetting competitive pressures working against this.

Finally, before leaving the internal common market, special attention should be paid to the consequences of globalization and international competitive pressures for the issue of the centralization or decentralization of powers. On the one hand, some would argue for decentralization on the grounds that a decentralized government is likely to increase competitiveness by being smaller and more efficient. Also, a smaller government itself will feel more compelled by competitive forces to be less intrusive. On the other hand, centralization of powers in some areas might actually contribute to a nation's competitiveness or to its response to global pressures. The enforcement of a larger internal common market can improve the growth process through faster transmission of technology and communications through mobile capital and labour.[2] Larger units will have greater bargaining power abroad [see Gotlieb 1991]. Also, centralization may improve the process of investment in human capital and research and development thereby contributing to competitiveness.

Local Public Goods and Externalities

One of the conventional efficiency functions of government is the provision of public goods. This is probably the role most often stressed in the public finance literature, though it is doubtful that it constitutes a significant proportion of what governments actually do on the expenditure side. Similarly, the traditional theory of fiscal federalism has stressed the role of local public goods as reasons for multilevel government [see, for example, Breton 1965; Oates 1972; and Breton and Scott 1978]. The conditions for the efficient provision of local public goods involve the sum of the benefits of all persons affected by the good. Different localities will generally prefer different levels of provision, and it is argued that local preferences will be better catered for if the local public good is provided by the appropriate local government.

Unfortunately, it is not possible to design the federation so that each local public good is served by the jurisdiction containing exactly those persons who are affected. That would presumably involve a very large number of jurisdictions. Thus the assignment of local public goods to jurisdictions may involve some overlap of benefits across jurisdictions. This means that there will be interjurisdictional spillovers. Again, much of the theory of intergovernmental grants has been directed to using matching grants to correct for such spillovers.

A major problem that arises with both the provision of local public goods and the correction of externalities is that the public sector does not have the information required to ensure that resources are allocated efficiently. In other words, there is no way of knowing the preferences that households have for public goods since there is no market through which these can be revealed. There is some literature starting from Tiebout [1956] which suggested that the ability of households to migrate from one jurisdiction to another will induce local governments to adjust the level of provision towards the optimum. However, this requires costless migration and that is unlikely to be the practice.

The appropriate level of government for the provision of local public goods and the correction of intergovernmental spillovers are obviously important policy matters to sort out. However, the literature devoted to them far outweighs their relative importance in federal economies. In fact, by far the most important expenditures of governments, including provincial governments, are either transfer payments or expenditures on essentially private goods and services. The reasons for this will be discussed more fully in the next chapter when equity considerations are analysed.

Some regulation functions may have a significant local public goods component to them. For example, if communities differ in language and culture, a case can be made for regulating them locally. This is addressed further in Chapter 6.

Fiscal Efficiency

The concept of fiscal efficiency is closely related to the efficiency of the internal common market discussed in a previous section. It reflects a particular source of inefficiency which is inevitable in decentralized federal systems. The problem arises because, in a federation in which economic decision making has been decentralized to provincial governments, the latter provide different *net fiscal benefits* (NFBs) to their residents. This means that the benefits of residing in one province relative to another include not only the relative earnings differentials between the two provinces, but also the differences in NFBs between them. To the extent that persons are mobile across provinces, they will allocate inefficiently since they will equate the sum of earnings plus NFB in the two provinces (net of any costs of moving), while economic efficiency involves equating only earnings net of moving costs.

The literature has recognized three sources for NFB differentials in a federation.[3] The first is a *fiscal externality* that arises in a model with local public goods.[4] The fiscal externality results from the fact that in an economy with local public goods, persons entering a locality do not take account of the fact that they jointly consume the local public good with other persons in the locality and reduce the tax burden to them from financing the public good. This source of inefficient migration has played an important role in the theory of fiscal federalism and the efficiency of migration. However, from a policy perspective, it is not clear that it is of fundamental importance for a couple of reasons. As already mentioned, the provision of public goods by provinces is a relatively unimportant part of their expenditure programs. Also, to the extent that public goods are provided by provinces, the direction of the efficiency effect is ambiguous and depends upon the preferences of persons for the local public good. This is information that is not known. The other two sources of NFB differential are likely to be much more important.

One arises from differences in source-based tax bases, especially taxes on resource rents. A province which has the larger such tax base can provide public services at lower tax rates than other provinces. This is an NFB which can give rise to inefficiencies in the allocation of resources. The second source of NFB differences results from the redistribution inherent in provincial budgets. The example commonly cited is the following. Suppose provinces provide public services which are like private goods, but they provide them in equal per-capita amounts to all residents. Suppose also, that provinces finance these public expenditures by a proportional income tax on all residents. Then, the budget has an overall redistributive effect. High-income persons obtain a negative NFB, while low-income persons obtain a positive NFB. However, if one compares across provinces, persons in low-average-income provinces will have systematically lower NFBs than those in high-income provinces, and the NFB differential will be the same for persons of different income classes.[5]

An interesting point about the above example is that it is relatively easy for the government to correct the NFB differential using a system of federal-provincial equalization transfers. In fact, the appropriate set of transfers would equalize fully all differences in tax capacity across provinces. In effect, as discussed in Economic Council of Canada [1982], this would replicate the financial arrangements of a unitary state but retain the benefits of decentralized decision making. This is discussed further later when we consider the theory of intergovernmental transfers.

It should be noted that there is some evidence to suggest that fiscal inefficiency is likely to be of limited quantitative importance, and therefore may not be a major argument in favour of equalizing transfers. Watson [1986], using data from Winer and Gauthier [1982], showed that the inefficiency caused by fiscally induced migration was likely to be small. It turns out, however, that the case for equalizing transfers does not rest solely on efficiency grounds. As discussed in the next chapter, equity arguments provide a strong justification for them.

Tax Harmonization

An important feature of federal economies is the fact that provincial governments have some degree of independence in tax policy.[6] Depending on how dissimilar are a province's taxes from federal taxes and from those in other provinces, there will be inefficiencies in the allocation of resources across borders. As already mentioned, differences in taxes can affect the flow of goods and services across borders, the flow of labour, and the flow of capital. To the extent that goods and services taxes can be levied on a residence basis, the distorting effect on these taxes will be felt more on labour markets.[7] Presumably, capital is much more mobile than labour; so the efficiency costs of different tax systems may be most important here. Much of the focus in the literature has been on capital income taxes for that reason.

The harmonization of direct taxes can take several different forms and can be of very differing degrees. In Canada, it has taken the form of a single-tax-collection administration for most provinces with a common base and rate structure for both the personal and the corporate taxes. The provinces retain the right to set their own tax rates and to implement nondiscriminatory credits. The federal government has the sole authority to set the base and rate structure. Provinces can choose to join or not as they prefer. This seems to be as much harmonization as would be compatible with the decentralization of taxes. Lesser degrees would include such things as provincial choice of the rate structure (as had been recommended by the Ontario Economic Council [1983]), joint decision making on the base, and joint administration. In the limit, provinces might administer their own tax systems, but might still adhere to federal bases. This latter is what is largely done for nonsignatory provinces in Canada and for many states in the United States.

There are several advantages of tax harmonization from the point of view of efficiency. First and foremost, it reduces the collection and compliance costs both for the private sector and the tax authorities. This is especially true if there is a single tax-collecting authority. Second, it reduces the possibility of double or non-taxation of income earned by firms operating in more than one jurisdiction. This is achieved by the use of a common allocation formula. Third, it reduces the possibilities of evasion and avoidance through such things as transfer pricing and financial transactions designed to reallocate tax bases to low-tax jurisdictions. Finally, it reduces the potential for tax competition among jurisdictions, if only by reducing the available instruments for such competition. In the Canadian case, there is a limit to the extent to which discriminatory provisions can be introduced into provincial tax systems to attract capital from other provinces. These efficiency benefits are especially important for tax bases applying to more mobile factors of production. In the next section, we consider some of the equity effects of tax harmonization. They will apply with more force to the personal tax than to the corporate tax.

The benefits of tax harmonization of the corporate tax base may come about to some extent without any formal agreement to do so – i.e., competitive pressure may induce a certain amount of similarity among provincial corporate tax bases. Presumably, the pressures will be greater the smaller are the provinces' bases relative to that of the federal government. However, there is a limit to the extent to which noncooperative harmonization can achieve an efficient outcome. For one thing, it is unlikely that anywhere near a fully harmonized system will result from decentralized corporate tax policy. In the United States, where most states administer their own corporate taxes, the bases diverge considerably both across the states and from that of the federal government. This is true despite the fact that the states occupy relatively little of the corporate tax field. As the provinces become more important in the corporate tax field, the pressures for harmonization are reduced. Provincial taxes have potentially a greater impact on economic activity the bigger are the tax rates. As mentioned above, tax competition can lead to beggar-thy-neighbour policies among governments, especially given the formula apportionment system used in Canada. Given these pressures, the literature on tax assignment has actually argued in favour of assigning source-based taxes on capital income, like the corporate tax or capital taxes, to the central level of government. Failing this, the next best thing is for the federal government to retain significant tax room in these bases so that they maintain an effective system of harmonization.

From an efficiency point of view, it can be argued that harmonization is less important in the indirect tax system given that indirect taxes are meant to exclude capital income. The main problems concern the inability to enforce the residency provisions of the tax. These can be circumvented by shopping across provincial borders.[8] Given that there are no border controls, it is not obvious that anything can be done about this. In fact, because of the absence of border controls, there will be competitive pressures for keeping sales tax rates and structures relatively similar.

Potentially more important efficiency issues arise in harmonizing the federal GST with provincial sales taxes. One thing is fairly clear here, and that is that it would be difficult to establish a harmonized GST system in which the provinces participated fully. Because of the crediting system used in the GST, transactions moving across provincial borders would have to be kept track of in a careful way to ensure that credits given for taxes paid at each stage went to the jurisdiction in which the original tax liability occurred. Presumably, that is one major reason why those provinces who have agreed to some harmonization with the federal system have done so while retaining their single-stage retail sales tax. Thus the full benefits of the GST system will not be realized, such as the removal of capital goods from the tax net and the nondiscriminatory treatment of traded goods.

Expenditure Harmonization

There may also be some efficiency advantages from harmonizing certain items on the expenditure side of provincial government budgets. A significant proportion of provincial government expenditures go to providing services of a quasi-private nature to households and also to making transfers.[9] There are two sorts of potential efficiency effects of such expenditures. The first is that interprovincial migration decisions could be influenced by differences in provincial expenditure programs. For example, the services offered under health-insurance programs may attract certain types of residents. More generous welfare schemes may induce in-migration of low-income persons, though there is little empirical evidence to support that view. The absence of portability of public pension schemes could affect the migration of the elderly. The possibility of migration responses to the design of expenditure programs could induce provinces to engage in a sort of expenditure competition whose aim was to attract desirable residents and repel less-desirable ones. If all provinces did the same, the end result would be that all are worse off. Thus there might be some advantage to coordinating such programs by the federal government.

The second is that some expenditure programs give rise to spillover benefits to residents of other provinces who can take advantage of the services being provided. The most commonly cited example is higher education. Residents of one province may attend the universities of another province thereby benefiting from expenditures done by the government of the latter. Transportation facilities are another example, as are health services. Again, there may be some advantages to central coordination from a purely efficiency point of view.

Unfortunately, there is rather limited evidence on the inefficiency effects of provincial expenditure programs. As such, it is difficult to build a strong efficiency case for the uniformity of provision. However, as with fiscal equalization, stronger arguments for expenditure harmonization may be found on equity grounds, to which we now turn.

5 Equity in a Federal Economy

Recall from our earlier discussion that part of what governments do is to facilitate the efficiency of the market economy – i.e., to increase the gains from trade in a general sense. However, much of what they do is concerned with improving the equity of the economy by redistributing the economic benefits of the market among different persons. Putting the equity objective into operation requires making a value judgment, typically captured by economists in the conceptual device known as a *social welfare function*. Different, but equally reasonable, persons will put different weights on equity depending on the value judgment they make. That makes the issue of policy evaluation difficult. In practice, the implementation of fairness or equity must ultimately be done through the political process. Our purpose in discussing the principle of equity in an abstract way using a social welfare function is simply to indicate the sorts of value judgments that must be made by the policymakers, and also to give some guidance to the question of which level of government should be primarily responsible for equity. As well, the theoretical discussion will help inform us as to what sorts of equity objectives or obligations, if any, should be included in the constitution.

Very different redistributive policies can be obtained depending on the value judgment one makes. It is useful to illustrate that point with a couple of examples. Suppose there are two types of persons in an economy and they differ in the amount of utility they get from a given amount of income. High-utility persons get higher levels of utility for any level of income than low-utility persons. Also, marginal utility declines with income. Suppose aggregate income in the economy is fixed, and the only decision is how much to give to each person. The socially optimal allocation of income depends on the form of the social welfare function. The important property of a social welfare function for redistributive purposes is its ***degree of inequality aversion***. As discussed in Boadway and Bruce [1984], social welfare functions with differing degree of inequality aversion can be written in the following general form:

$$W(U_1,U_2,\ldots,U_n)=\sum_{i=1}^{n}\frac{(U_i)1-\rho}{1-\rho},$$

where ρ is the degree of aversion to inequality. If $\rho = 0$, the utility function is utilitarian (the sum of utilities). Social indifference curves in utility space are straight lines with a slope of −45 degree. As ρ approaches ∞, the social welfare function becomes maximin or Rawlsian. Indifference curves are right-angled along the 45-degree line. In between, different degrees of aversion to inequality are possible, and social indifference curves are strictly convex to the origin. As the value of ρ increases, the curvature of social indifference curves increases, differences in utility levels are tolerated less, and the distribution moves in favour of the low-utility persons. However, as mentioned, virtually any pattern of progressivity is possible.

Consider now the effect of the degree of inequality aversion in the given example. We focus on two extremes – utilitarian and maximin. If the social welfare function is utilitarian, so that all that matters is the sum of individual utilities, income is distributed optimally when marginal utilities of income are equalized for the two persons. In this case, more income is given to the high-utility persons than to the low-utility persons, and the high-utility persons end up with both a higher level of utility and a higher income. This might be regarded as an inegalitarian outcome. On the other hand, if one takes as the social welfare function the maximin one, income would be redistributed so that utility levels are the same across all individuals. Unlike the utilitarian case, this requires that more income be given to low-utility persons, since they require more income to achieve a given level of utility. Thus the extent of redistribution depends critically on the form of the social welfare function.

A second example allows for variability in labour supplies. Suppose the economy consists of two types of persons – a high-wage and a low-wage person – and each has identical utility functions which depend both upon income and leisure. The fact that leisure yields utility turns out to have an important bearing on the degree of redistribution. Suppose also that lump-sum taxation is available so as to avoid problems of efficiency. In this case, very different redistributive outcomes are again possible depending on the degree of aversion to inequality in the social welfare function. If the social welfare function is utilitarian, the redistributive lump-sum tax is highly progressive, so much so that it makes the high-ability person worse off than the low-ability person.[1] However, if the social welfare function is maximin, the redistributive tax is much less progressive and can even be regressive.[2] Thus, again, the extent of redistribution varies considerably with the value judgment taken.

In practice, lump-sum taxation is not available to the government. Redistributive policy has to be based on what the government is able to observe. The most commonly discussed and analysed instruments for redistribution are based on income on the grounds that income differences reflect differences in the ability to earn income. The tax-transfer system tends to be based largely on income, and most people think of the tax-transfer system as being the main source of redistribution in the public sector. However, redistribution according to income turns out to be a rather dull instrument for a variety of reasons. Income differences reflect many things besides differences in the ability to earn income. For example, they reflect differences in work effort, differences in educational attainment, differences in occupational choice (i.e., working in occupations with different nonpecuniary attractions, working as an employee as opposed to as a manager or entrepreneur, and so on), and differences in age. The fact that these things differ across households, and that some of them can change in response to income taxation, implies that taxation based on income alone is of limited use. The theoretical literature on the optimal income tax has attempted to take these things into account in determining the desired degree of progressivity of the income tax. The analysis is very technical and has largely resorted to simulation studies. For a wide variety of assumptions about individual behaviour, the distribution of skills and the social welfare function, the progressivity of the optimal income tax is surprisingly limited.[3]

The traditional theoretical literature on redistribution has focused on utility differences arising from variances in the ability to earn income. However, there are a number of other characteristics of households which affect their utility and which, therefore, might be used as the basis for redistributive policy. These include health status, disability, employment status, age cohort (i.e., date of birth), family status, location of residency, and so on. Since these characteristics can give rise to differences in utility level (assuming they cannot be costlessly changed by the household), redistributive policies based on them can be important components in the redistributive arsenals of government. In principle, there are a large number of ways to make redistribution dependent on these characteristics. The income tax system itself can be, and is, used for that purpose. Thus family status, age, day-care costs, and disability are often used as the basis for deductions, exemptions, or credits under the income tax. The transfer system may also be used to correct for differences in these characteristics. Examples of this include family allowances, public pensions, and unemployment insurance. Transfers in kind offer another way of accomplishing equity goals in ways not related to income. Health insurance and welfare services are examples of this. More generally transfers in kind which are not necessarily related to nonincome characteristics are often used as instruments for redistribution. Such things as public education, public housing, and, in some countries, food programs can be thought of as in-kind redistributive instruments.

The upshot is that, along with the income-based tax-transfer system, there are a variety of other instruments that may be used for redistributive purposes. They include both instruments based on nonincome characteristics, often referred to as social insurance programs, as well as in-kind transfers. The literature on these types of redistribution is still in its infancy. However, there have now been a number of papers which have argued that both types of instruments have a role to play in a general system of redistribution. It is relatively straightforward to make the case for social insurance programs based on nonincome characteristics. Examples include Gordon and Varian [1988] for the case of intergenerational equity, Blomqvist and Horn [1984] for health-based redistribution, and Boadway and Wildasin [1990] for the case of redistribution based on uncertain shocks to particular occupations. However, the use of in-kind transfers as opposed to cash transfers involves more subtle forms of analysis. In the literature, various cases have been derived in which in-kind transfers can actually improve the efficiency of the redistributive process. The general phenomenon has been analysed by Guesnerie and Roberts [1984], who show that even with optimal income taxes some forms of quantity rationing may improve social welfare. Nichols and Zeckhauser [1982] provide a good intuitive explanation for the use of in-kind transfers for redistributive purposes. This notion has been applied to health care by Blackorby and Donaldson [1988], to education and pensions by Boadway and Marchand [1990], to public expenditures in developing countries by Besley and Coate [1991], to minimum wages by Guesnerie and Roberts [1987], and to unemployment insurance by Marceau and Boadway [1991].

We need not be concerned with the technicalities of that literature. What is more important is to recognize the extent to which what governments actually do is motivated by redistributive goals. Such government expenditure programs as health care, pensions, unemployment insurance, welfare services, workman's compensation, public housing, and education are largely devices for redistribution. In most of these cases, it would be difficult to justify public provision except on redistributive grounds. The programs are either outright transfers, or they are the public provision of essentially private goods which could readily have been provided through the private sector. In fact, a close inspection of what governments actually do reveals that a very high proportion of it is redistributive in nature. We are not in a position to say whether this is a good thing or not.

Instead, we treat it as a fact which must be recognized in the design of the constitution.

This fact is of critical importance in evaluating options for the Canadian federal system. Many of the programs which are redistributive in nature are now the legislative responsibility of the provinces. Basically, everything in the areas of health, education, and welfare, with the exception of unemployment insurance, are provincial responsibilities. Pensions are shared between the two levels, though, in fact, most provinces choose not to exercise the option. This significantly reduces the ability of the federal government to pursue equity objectives in a direct way except through the income tax-transfer system. Based on the above, the income tax-transfer system is only a part, perhaps a small part, of the overall system of redistribution through the public sector.

Before addressing in more detail the special issues of equity that arise in a federal system, it is useful to recall the conventional way that public finance economists have disaggregated the problem of equity into horizontal and vertical equity components. The disaggregation is based on the idea that equity concerns are ideally implemented through some social welfare function in which the arguments are the utility level of different individuals. Typically, the social welfare function has the properties of anonymity and symmetry, which say that only the utility level of each person matters and not the person's identity, and that the weight given to two persons with the same utility level should be the same. Social welfare functions also specify the trade-off between persons of different utility levels. Given this, redistributive equity can conceptually be divided into a sequence of two stages. In the first stage, persons who are equally well off are identified. The principle of horizontal equity says that persons who are equally well off in the absence of government ought also to be equally as well off in its presence. It is thus a principle of equal treatment of equals. In theory, the way in which persons equally well off are identified is as follows. A monetary measure of the level of welfare of a household is arrived at. In the welfare economics literature, the notion of an expenditure function at a set of reference prices is used. This is referred to as a *money metric* measure of utility and represents the real income of the household. It can be corrected by the use of household equivalence scales to include such things as family size. Persons with equal real incomes are then treated equally by the public sector.[4]

The principle of horizontal equity requires that one be able to compare levels of utility across households. Vertical equity involves the treatment of persons who are at different levels of utility. It involves making a value judgment about how to trade off changes in utility to persons who are at different levels to begin with. The concept of the degree of inequality aversion, introduced above, is a useful summary measure for that purpose. This distinction between horizontal and vertical equity has been important in the literature on fiscal federalism.

As in the case of efficiency, there are some special issues that arise in addressing the objectives of equity in a federal state. We discuss two important ones here.

Federal versus Provincial Responsibility for Equity

A major issue in the debate over the centralization or decentralization of economic functions is who should bear the responsibility for equity, the federal government, the provincial government, or some combination of the two. This is especially important given that, as discussed above, a good deal of what governments actually do is directed towards equity objectives. Some of the economic issues involved are discussed in the next chapter. Here, we might simply point out the apparent division of responsibilities that exists now. Until the Constitution Act of 1982, the responsibility for equity was not explicitly spelled out. However, both governments undertook functions which had equity consequences. The federal government basically had control over income-based redistribution, while the provinces were responsible for health, education, and welfare services. The federal government exercised some influence over the delivery of provincial services through the spending power, and that was presumably largely motivated by equity considerations.

The Constitution Act of 1982 stated in more explicit terms through Section 36(1) that equity was a joint responsibility of the federal and provincial governments. At the same time, it obliged the federal government to pursue interprovincial and interregional equity by Section 36(2). It is not at all clear what the force of these provisions is in law. One constitutional lawyer's point of view of Section 36(2) is expressed as follows: "This obligation is probably too vague, and too political, to be justiciable, but it suggests that equalization payments will continue into the foreseeable future" [Hogg 1985, 34]. Further on, Hogg says "Section 36 of the Constitution Act, 1982, expressing a commitment to redressing regional disparities and to making equalization payments, also seems to reinforce by implication a broad interpretation of the spending power" [Hogg 1985, 126]. One way of interpreting these provisions is to suppose that the provinces have the ability to pursue redistributive policies within their own jurisdictions. At the same time, the federal government has an overriding responsibility for national equity, especially for ensuring that provinces have similar financial capacities for exercising policies for equity objectives. We return to the assignment of equity functions in the following chapter.

Fiscal Equity

An analogous concept to that of fiscal efficiency discussed in the previous chapter is that of fiscal equity. This is basically the concept of horizontal equity applied in a federal setting. As we have seen in discussing fiscal efficiency, in a decentralized federation different jurisdictions provide different NFBs to their residents. These NFB differentials come about from differences in source-based tax revenues (e.g., resource and corporate taxes) and from the redistributive component of provincial government budgets operating through residence-based taxes. There may also be NFB differentials arising from differences in the cost and need for public services across provinces. For example, provinces with a higher proportion of elderly will need proportionately greater expenditures on health and welfare services. This means that otherwise identical persons will be treated differently by the government sector, specifically by the provincial governments. In other words, provincial public sectors will violate the principle of horizontal equity in a federation.

Furthermore, in the absence of measures to offset these provincially induced NFB differentials, the federal tax-transfer system will also violate horizontal equity. The reason is that the base for the federal tax will include observed income, but will not include NFBs which are equally a source of real income. Thus persons in high-NFB provinces will be treated favourably relative to those in low-NFB provinces in the sense that a greater proportion of their real incomes go untaxed.

In principle, this situation could be remedied by a system of transfers to individuals which is based on the NFB they receive from their provincial government. However, such a system would be extremely complicated to administer and would be open to incentives for provinces to change their behaviour in order to take advantage of the federal transfer to their citizens. More importantly, it would be equivalent to the federal government overriding entirely the redistributive policies undertaken by the provinces, and this may be incompatible with the assignment of equity responsibilities. Instead, the NFB differentials may be addressed through a system of equalizing transfers. As discussed in Boadway and Flatters [1982] and Economic Council of Canada [1982], these transfers should equalize tax capacities across provinces, and they might also include some equalization of need and costs. The extent to which the existing system of transfers achieves this goal is discussed in a later chapter. For now, it is worth noting that equalization in this general sense is accomplished by more than the formal Equalization system itself. The CAP can be interpreted as equalizing according to need and to negative tax capacity. The EPF system is itself implicitly equalizing as well.

Note finally the interesting point that the existence of NFB differentials call for some equalizing transfers on both the equity and efficiency grounds. This is one of those few instances in which equity and efficiency considerations go in the same direction. In fact, however, equity and efficiency considerations may not call for exactly the same extent of equalization. For example, in the case of resources rents collected by the provinces, efficiency would call for their full equalization. Equity would call for less to the extent that the ownership of the resources was deemed to be in the hands of the residents of the province, as seems to be the case for Canada. As argued in Boadway and Flatters [1982] and Economic Council of Canada [1982], the share of resources rents equalized in this case would only be the average rate of federal tax times the resource rents, since the resource rents collected would be deemed to be legitimate components of the real income of households.

6 The Division of Economic Responsibilities

This chapter will discuss the various *economic* arguments for dividing the economic functions of government between the federal and provincial levels of government – i.e., the balance between centralization and decentralization.[1] It is worth at the outset making explicit a couple of caveats about the force of our arguments. First, we consider only the economic arguments for the assignment of responsibilities. It is not at all clear that economics will be the determining factor in settling these matters. Second, and most important, economists do not agree among themselves about the assignment of functions in the federation, as is patently evident from the current constitutional debate.

There are several sources to this disagreement. At one level, there is simple disagreement about the actual consequences of decentralization. Some economists are predisposed towards decentralization as an efficiency-enhancing device. The general idea seems to be that decentralization to small units of government will bring collective decision making closer to the people and make it more responsive to local desires. Similarly, adopting the analogy with the market mechanism, there is some feeling that the decentralization of government decision making will induce intergovernmental competition which will lead to increased efficiency.[2] Others see decentralization as a mixed blessing, since it can cause wasteful tax and expenditure competition, duplication of functions, disruption of the common market, and failure to take advantage of economies of scale. It is probably fair to say that there is simply not enough evidence to support either point of view with any degree of confidence.

Perhaps the more significant source of disagreement in the debate over centralization versus decentralization has to do with the role of government itself. Some of the economic arguments in favour of decentralization stem from a general dissatisfaction over the size of government *per se*. This is a characteristic of the public choice school of economists. They would prefer less government and see decentralization as an ideal system in a world of less government. The notion is that this will induce less government by some mechanism of intergovernmental competition. This seems to be a common thread running through many of the contributions arising out of the Bélanger-Campeau hearings. The argument is a fairly general one, and there is little evidence to support or reject it.

Related to this is the fact that different economists attach different weights to equity relative to efficiency objectives of the government. Indeed, much of the argument for minimal government by Buchanan and his followers stems from a profound distaste for the redistributive activities of the government [see, for example, Brennan and Buchanan 1980]. As we discuss further later on, equity considerations could be taken to argue more in favour of centralization than efficiency considerations. Much of the concern about decentralization that has been expressed in the public debate turns on equity arguments ultimately. Those who take the view that governments should be primarily involved in enhancing the efficiency of the market economy tend to support a decentralist view of the division of powers. In evaluating these various arguments, it is worth remembering that, as discussed above, a good deal of what governments in Canada actually do is of a redistributive nature. It is therefore fruitful to address the centralization versus decentralization issue with that in mind. Thus, for most of the discussion, we consider the assignment of functions under the assumption that governments continue to perform the services they are now performing.

The problem of assigning functions boils down to that of deciding which level of government performs which services, and how each level of government finances its expenditures through a mix of taxes and, in the case of the provinces, federal transfers. The expenditure and tax assignments can be done relatively independently, with the aggregate differences being ultimately reconciled by federal-provincial transfers. In fact, the role of transfers becomes a crucial component of the arsenal of federal government instruments to the extent that equity issues are assigned to the federal level. We devote a separate section to the principles of intergovernmental transfers since they are rather crucial in the economics of federal systems of government.

We begin by discussing some general principles involved in the assignment of functions and then consider the consequences of these for constitutional design.

General Principles Affecting the Assignment of Functions

The Assignment of Equity

An overriding general issue is how the responsibility for equity should be assigned to the two levels of government. This is important as an issue in its own right, but also because the assignment of equity responsibilities will have an effect on the weight that equity assumes in public-sector decision making. Much of the dispute between economic centralists and decentralists amounts to a disagreement over the assignment of equity functions, if only implicitly. Efficiency arguments are relatively more straightforward to deal with.

One general problem that arises immediately is that it is inherently difficult to articulate exactly how to assign equity since virtually everything governments do will have redistributive consequences. Thus it would seem to be impossible to assign equity exclusively to one jurisdiction or another. Rather more general statements of principle might be the extent of the assignment. This is the case in the current Canadian federation where Section 36 basically assigns the equity responsibility jointly to the two levels of government. What is probably more important than the constitutional prescription is the practice.

The conventional view from the public finance literature [e.g., Musgrave 1959] is that equity should ultimately be a federal responsibility. The main argument for federal primacy in equity is the horizontal equity notion that persons ought to be treated the same regardless of their province of residence. In technical terms, the social welfare function should apply nationwide and should treat all citizens on a symmetric basis. There are also some efficiency arguments for putting equity at the central level, such as the avoidance of tax and expenditure competition which will partly prevent equity goals from being achieved and the maintenance of the free flow of factors of production.

This argument for symmetric treatment of all citizens seems to be a fairly compelling one. Unfortunately, it does beg a number of questions. For one, it presumes that governments operate as benevolent social-welfare maximizing institutions, rather than as self-interested "leviathans" interested primarily in transferring resources in favour of their supporters. For another, even if governments were benevolent, there will not be an agreed-upon social-welfare function for the society. This is a well-known consequence of the *Arrow Impossibility Theorem* [see Arrow 1951]. Equity judgments must be made by someone, and it is not obvious that those of the federal government are in any way superior to those of the provinces.

On the contrary, one might expect that preferences for redistribution differ from one province to another, and that there should therefore be scope for provincial implementation of equity objectives. Indeed, some would put large emphasis on the provincial role for redistribution based on the following argument. As Pauly [1973] has noted, some redistribution can be justified on the basis of altruism, and altruism may apply largely to persons in one's own community or province. If so, redistribution takes on the characteristics of a local public good and may be more efficiently provided provincially.

In the end, given these competing arguments, perhaps some joint responsibility for equity is called for. The Constitution Act of 1982 recognizes this by assigning joint responsibility for equity objectives to the two levels of government. As well, the practice is to allow provinces to implement redistributive policies on their own. In fact, one of the objectives of unconditional equalization transfers to the provinces as spelled out in Section 36(2) is to equalize the ability of the provinces to pursue similar objectives while at the same time letting them exercise that responsibility independently. Perhaps the compromise that has been reached in the workings of the Canadian federation is not a bad one. The provinces undertake their own redistribution, but the federal government retains the right (or responsibility) to ensure that different provinces have the same opportunity to redistribute by making equalizing transfers. Conflict naturally arises when the two levels of government attempt to pursue contradictory redistributive policies. For example, as argued later, the use of conditional grants can be viewed as a mechanism for the federal government to impose its views of national equity on the provinces. Where these differ from provincial priorities, disagreement occurs.

The upshot is that despite the importance of the assignment of responsibility for equity, it is not altogether clear which level of government ought to assume responsibility for it. Nor is it clear how responsibility can be assigned in the abstract. However, the cases for centralization or decentralization should not be made without making explicit one's view of equity objectives. My own inclination is to accept a major role for the federal government in equity, though others may well draw a different conclusion.

Spillovers and Public Goods

Traditionally, much of the analysis of the assignment of powers from an economic perspective has been stated in terms of public goods and externalities arguments.[3] The idea is that most of what governments do for efficiency reasons can be viewed as a type of public good.[4] The geographical scope of beneficiaries from public goods can cover varying degrees. In the case of public goods and services which give benefits to persons across several jurisdictions, central responsibility for provision is usually preferred. This ensures that those being served have a voice in the political process which determines the amount of expenditures. For others who have their main benefits within a given province, but who cause spillover benefits to other regions, the use of matching conditional grants is usually suggested. This is the exact analog of Pigouvian taxes and subsidies for the correction of externalities.

In fact, the provision of public goods and services probably constitutes relatively little of what governments actually do. As we have seen earlier, a very large proportion of what governments spend is on transfers. Of those which are on goods and services, a good part is on "quasi-private" goods and services – i.e., goods which have the characteristics of being private. (These are discussed next.) Thus the public goods argument does not get us very far in defining the division of responsibilities, and as far as it goes it tends to be non-controversial.

There may, however, be externalities or spillovers associated with spending on quasi-private goods. For one thing, they may be available for the use of non-residents, as in the case of postsecondary education and health services. Or, residents of a particular province may use them and then change residency. Finally, some quasi-private goods themselves give rise to spillover benefits to other provinces. The provision of welfare services by one province may induce in-migration and thus benefit those living in other provinces. Thus there are common market aspects to quasi-private goods, and some central role may be required for efficiency even if they are provided by the provinces. For example, the use of conditional grants and national standards may be justified.

Provision of Quasi-Private Goods

As mentioned, much of what comprises government spending on goods and services is on those which are essentially private in nature. However, they are typically provided through the public sector without making full use of prices as allocation devices. Examples include education, welfare services, and various types of insurance referred to in this context as social insurance. Unlike public goods, quasi-private goods have as their main beneficiaries those in the jurisdiction in which they are provided, whatever that may be; though, as mentioned, there may be some spillover benefits associated with them. Thus there is an a priori reason for lower level provision. There may, however, be economies of scale which would set a lower desirable limit on the level.

Decentralizing their provision to the provinces has a number of alleged advantages. It allows the public sector to be more responsive to local tastes. It is argued that governments are more accountable for what they provide if the provision is at a lower level. Decentralization is also said to induce competition among provincial governments which is said to lead to incentives for more cost-effective provision as well as for innovation. For these reasons, many federations, including Canada, rely heavily on provincial governments or their equivalent to provide most quasi-private goods.

It is not always made clear what is meant by intergovernmental competition in services. What seems to be meant is that governments must compete with each other to attract residents and so must provide goods most suited to the needs of prospective residents. This type of argument goes back to Tiebout [1956]. Unfortunately, there is not a great deal of evidence to support this claim; i.e., it is not clear that competition to satisfy existing and prospective residents in fact leads to more efficient government. Indeed, to the extent that competition is effective, the argument can be turned on its head. Interprovincial competition for residents and capital can be self-defeating and can lead to wasteful beggar-thy-neighbour tax and expenditure competition. Provinces may tailor their programs to try and attract certain types of persons, and they may reduce the levels of their services too much in competing with one another. Thus it is not clear that competition between governments is, on balance, a good thing.

Nonetheless, the arguments for provincial provision are fairly compelling ones, as well as being facts of life. Even so, the federal government may retain an interest in the provision of them for a number of reasons. First, because some of them have significant spillover effects, their provision might be too low without some form of national intervention. Welfare systems, postsecondary education, and transportation facilities are examples of quasi-private goods provided by the provinces which can have spillover benefits to neighbouring and other provinces. Second, if provinces have very different forms of service, and if they are not portable, the common market in factors of production may be fragmented. Persons may be reluctant to move from one province to another if that involves changes in their public-sector benefits. This may be especially important when considering the fact that benefits and tax liabilities typically occur over different points of the life cycle. When one is in a taxpaying position (e.g., in mid-life), one is a relatively low consumer of public services. The opposite holds at the beginning and the end of the life cycle. Migration can work to the benefit of some provinces and to the disadvantage of others depending upon the demographic characteristics of migration. Third, and of critical importance, the provision of quasi-private goods typically has redistributive equity as its main objective, as discussed further below. If the federal government bears some responsibility for national equity, it will have an interest in seeing some form of national standards applying to these goods. Finally, there may be significant economies of scale in the provision of some quasi-private goods which might justify some centralization of their provision. For example, many of them have considerable administrative overhead which makes the per-capita cost quite high for at least some sizes of provinces.

These arguments might suggest that, although the provincial governments are best placed to be responsible for providing most quasi-public goods through their own legislation, the federal government has an interest in coordinating the form of that provision. Basically, the only way open to them would be through the use of the spending power. The past practice in Canada for the federal government to influence provincial spending in areas of provincial jurisdiction can ultimately be justified by the above arguments. Probably the most important one of these, and the one which justifies the major interventions in the past, is the equity argument. Again, one's views about the intervention of the federal government through the use of the spending power are conditioned by the weight that one gives to equity in general and its assignment to the federal government in particular. These both involve value judgments.

Regulating the Internal Common Market

The preservation of the internal common market is often regarded as being one of the important objectives of public policy in a federation. For example, it seems to be a standard feature of proposals coming out of Quebec. Preserving the common market means, in principle, guaranteeing the free and nondistorted flow of all goods and services, labour, and capital. In a sense, the decentralization of powers to the provinces is almost bound to interfere with the smooth functioning of the internal common market, since decentralization is likely to lead to at least some divergence in provincial policies. Otherwise, there seems little point to it. Thus maintaining the complete integrity of the common market is likely to work in favour of centralization and will have to be traded off against other arguments for decentralization on a case-by-case basis. On the other hand, some might argue that given the increased degree of global competition, provinces are likely to be highly constrained in their use of potentially distortionary policies.

There are several circumstances in which this may be of importance. Governments are often involved in regulating the activities of industries producing goods and services. To the extent that these are traded across borders, common market considerations would suggest some federal role. As Maxwell and Pestieau [1980] describe, centralization has led to distinct areas of specialization in Canada, allowing higher Canadian incomes and employment to result from increased efficiency. Ontario and Quebec have become dominant in manufacturing/industrial production, while the western and Atlantic provinces are dominant in primary/resource production. However, resource-based specialization can lead to a province being vulnerable to "unbalanced growth" because of fluctuations in the demand for its products and a narrow range of job opportunities. In general, national specialization is consistent with country building, but not so consistent with province building. A policy of province building gives individual provinces an incentive to pursue diversification (usually focusing on manufacturing and high-productivity industries) at the expense of the potential benefits of national specialization.

Most provinces follow some explicit policies to promote diversification as well as more decentralized decision making. The most common examples are: financial assistance to businesses willing to locate in the province, including tax concessions, grants, loans, and subsidies; discriminatory policies for local firms in government purchases; and market intervention through marketing boards dictating production quotas and selling prices, takeovers of private firms, and moral suasion on private decisions.

A second result of province building has been provincial lobbying against certain federal policies. In nearly all cases, provincial claims for a fairer deal inevitably lead to conflicts of interest between regions. Examples of provincial discontent include the West's grievance that tariff and transportation policies are discriminatory, especially freight rates; the Maritimes' resentment of the St. Lawrence Seaway since it causes Maritime ports to be bypassed; also their grievance that the establishment of fishing rights on the continental shelf has been delayed; Quebec's grievances regarding the Auto Pact, the St. Lawrence Seaway, and the national oil policy developed in 1960.

One can also find other examples in such areas as agriculture, transportation, communications, and energy. In each of these cases, there may be arguments for decentralization (e.g., the protection of culture) that must be traded off against fragmentation of the common market. Similar regulatory arguments apply to markets for factors of production. The regulation of capital markets and financial institutions at the provincial level can induce some interference with the free flow of capital. However, the extent of that may be limited given the dominance of the Securities and Exchange Commission in North America and the increasing importance of the Bank for International Settlements internationally. In the case of labour markets, manpower and employment policies and regulation of professions at the provincial level can lead to restrictions on the free flow of labour across boundaries.

The point is that virtually any decentralization of regulatory functions is likely to lead to some balkanization of the common market. Although all provinces realize the potential efficiency costs of balkanization of the Canadian federation, their incentives to pursue province building often lead to interventions that impede the common market. A cost of decentralization is that these province-building incentives are increased, and this should be considered for the desired level of centralization.

More generally, provincial government taxing and expenditure policies are likely to interfere with the free flow of goods and services. Different corporate tax rates and different levels of provincial services to the private sector will affect the allocation of capital in the federation. Different income tax rates and different levels of public services will give rise to net fiscal benefit differentials which will influence the efficiency of the allocation of labour across the provinces. To some extent, the federal government can counteract these effects by equalizing transfers designed to undo the differences in net fiscal benefits across jurisdictions. This is presumably part of the intent of Section 36(2) of the Constitution Act of 1982.

As mentioned earlier, the federal government is not immune to undertaking policies which distort the economic union, as the examples of unemployment insurance and regional subsidies amply show. For this reason, it might be suggested that putting the principle of the common market (free flow of goods and factors) directly as an obligation into the constitution might be appropriate. This may also mean giving the federal government the additional power to enforce the provision.

In the Canadian context, one of the key arguments for the decentralization of economic powers advanced in Quebec is the necessity to protect language and culture, both of which are said to differ significantly from the rest of Canada. While, to some extent, this may seem like a non-economic issue and therefore beyond our purview, it is possible to put an economic interpretation on language policy. As Vaillancourt [1991] has pointed out, the value of the human capital of a francophone worker depends upon the language policy being pursued, especially language in the workplace. Policies which promote the use of French in Quebec can be thought of like a public good which has both equity and efficiency implications. Vaillancourt argues that a good case can be made for decentralizing economic functions to Quebec, perhaps selectively, which affect language and culture. On the other hand, Brenner [1991] argues that such policies can be counterproductive in the long run and can also be costly in terms of individual freedom.

Tax and Expenditure Harmonization

There is a large literature on tax harmonization between jurisdictions which has relevance for the constitutional reform debate. Harmonized taxes, especially income taxes, are said to have several benefits including reduced compliance and enforcement costs, removal of distortions in the free flow of capital across jurisdictions, reduction in the possibilities of tax competition, and the ability to pursue a common redistributive policy. There are probably three overriding considerations which have a bearing on the assignment of taxes. One is that the more "mobile" the base, the stronger is the argument for centralization. Thus taxes on capital income are best coordinated centrally. Second, to the extent that equity is a federal concern, central control over direct taxes is important since these are the taxes best designed to address equity issues. Third, it should be recognized that the arguments for centralization on the tax side might be much stronger than those of the expenditure side. This is recognized in many federations which have much more centralization of revenue collection than of expenditures. The difference is reconciled by some combination of grants and tax sharing.

Later we discuss further the actual assignment of taxes. However, a couple of other things might be noted. The first is that central control over a tax base need not rule out some sharing of the base between the two levels of government. In Canada, we have had a very effective method of tax harmonization through the Tax Collection Agreements, even though the income tax fields have been shared by the two levels. Maintaining an effective such system does require a dominant position of the federal government. The second is that there is a basic symmetry between taxes and transfers; transfers are negative taxes. Thus many of the arguments which apply to the assignment of taxes also apply to that of transfers. Of course, transfers can be designed on quite different bases than taxes, so the symmetry is not exact. We return to this later.

Similar arguments might also be used to harmonize some items on the expenditure side, for example, in the areas of health, education, and welfare. We turn to these areas now.

Transfers and Social Insurance

As mentioned several times already, a significant proportion of government expenditures, especially federal, are in the form of transfers (to individuals or businesses). The question is at what level should these be provided? A number of considerations are relevant in deciding the assignment of transfers. First, most of the transfers to individuals are for redistributive purposes. Thus the issue of which level they should come from is related to the question of which level of government is primarily responsible for equity. Second, from a purely economic point of view, transfers are like negative direct taxes. Thus there is an argument for them being integrated with the direct tax system and being subject to the same sort of harmonization arrangements. Third, there are several different types of transfers ranging from welfare to pensions to unemployment insurance. It is helpful for there to be some coordination (harmonization) in the provision of these various sorts of transfers among governments. This includes not only between the two levels of government, but also across provinces. There are well-known difficulties and adverse incentives resulting from the current system under which the federal government provides unemployment insurance, but the provinces provide welfare payments. Finally, transfers to business are most often for incentive reasons. Common market arguments might suggest that these be mainly at the central level so as to prevent wasteful competition for business and a fragmentation of capital markets.

Other Issues Arising from the Federal Responsibility for Equity

The implications of assigning the federal government primary responsibility for national equity, if that were the chosen option, could be quite significant from the point of view of federal-provincial fiscal arrangements. Indeed, it could well be the major determinant of the degree of centralization. For example, it has implications for the assignment of taxes. In particular, it would argue in favour of federal dominance in the direct tax fields, including in the setting of the rate structure. Also, it could be used as an argument for federal predominance in the area of transfers to individuals. By the same token, if it is recognized that expenditures in the health, education, and welfare services areas are largely redistributive in nature, assigning these responsibilities to the provinces would remove an important set of instruments for equity from the federal sphere. The use of the spending power to induce national standards of equity could be made. Finally, the role of federal-provincial equalizing transfers becomes more important to the extent that the federal government is assigned the role of fostering national equity. This is discussed more fully in the next section. Thus there is a great deal at stake in deciding the role of the federal government in achieving equity. The current system seems to assign the federal government considerable equity responsibility.

Consequences for the Assignment of Powers

Our main concern in this section is to consider the implications of the above principles for the division of economic powers between the federal and provincial levels of government. We address this issue from an economic point of view rather than a constitutional one. We have also stressed that the assignment of powers is partly contingent on one's views about the role of government in the economy *per se*. Arriving at a position about the role of government in the economy and how this should be divided between levels of government is only part of the problem. It is also necessary to know how this ought to be reflected in the constitution – i.e., what the constitution should say about the responsibilities of governments, the constraints on their actions, and their obligations. It is not a trivial issue to decide what should be left to legislative decision making and what should be imposed on all legislatures through the constitution. The economic literature on this matter is in its infancy, and we have little to add to it here.

It does seem that three sorts of reasons might be advanced for putting economic responsibilities and obligations in the constitution. One is simply to protect the integrity of the market mechanism and the system of property rights on which it depends. Another is to protect minorities of various sorts from being exploited by majorities, especially more or less permanent ones, through the democratic process. The final one is to impose commitments on government to overcome what is known in the economics literature as the "time consistency" problem. This is the problem that arises because of the fact that governments have an incentive to renege on their past commitments, even though from a long-run point of view, society would be better off by not having the reneging take place. Arguments of this sort have featured prominently in the macroeconomic policy area and have been responsible for such recommendations as limits on the size of debt and nondiscretionary monetary rules.[5] We are in no position to sort out the constitutional design issue as opposed to the economic division of power issue. However, some reflections are presented here to provoke thought more than anything else.

One extreme way to put the constitutional design question is to undertake the mental exercise advocated by the so-called contractarians.[6] The exercise is to imagine oneself being behind the "veil of ignorance" in which self-interest is eliminated completely. For example, one could imagine being in a state of pre-birth where one had an equal chance of being born as anyone in society. Given this setting, one asks oneself what kind of measures should be incorporated into the constitution to regulate how governments behave. In other words, if we could eliminate self-interest, what would the constitution allow? This is quite a difficult exercise to imagine engaging in since it is hard to eliminate one's values completely, and different persons will have very different views as to their preferred constitution. However, from my point of view, the following might be thought of as reasonable basic requirements for the constitution: it should preserve the best properties of the decentralized market economy, while at the same time admitting an appropriate allocative and stabilization role for government; and it should oblige governments to fulfill certain modest equity obligations.

Setting aside for the moment the special features of a constitution for a federal (as opposed to a unitary) state, these objectives might suggest that the constitution have the following general characteristics:

1 The need to define and protect private property rights (security, the rights of private contracts, and the right to engage in trade).

2 The need to define public (common) property, such as the natural resources of the country.

3 The ability to regulate trading in markets for both goods and services and for factors of production (i.e., labour and capital), including dealings with non-residents, for the common good.

4 The rights of governments to tax and engage in trade for the common good, as judged by the good of individuals in society (both present and future); since this involves the violation of private property rights, it needs to be carefully specified; some property might be inviolable (e.g., the rights of a person).

5 Control of the currency via control of the central bank, which might be largely independent of the government of the day.

6 An expression of the equity obligations of government to include the promotion of equal opportunities (the analog of Section 36(1) stated already), the elimination of poverty and non-discrimination; ideally, the wording of this part should be such as to oblige governments to the pursuit of *some minimal* degree of equity, while at the same time recognizing the constraints imposed by efficiency. This might be thought of as part of a charter of economic rights along with item 1 of this list.

Many persons (especially economists) might dispute the necessity for item 6 in this list, preferring instead to leave matters of equity to the government of the day. This is obviously a matter of judgment, though not an inconsequential one. My feeling is that where equity is concerned, it may be useful to provide some inducement to the promotion of fairness or economic justice for government, since, as is well known, majority rule might not always be compatible with one's abstract notion of equity.

It remains an open question as to whether or not other constraints and obligations of a general sort might be put into the constitution. We have already suggested including the principle of a free flow of goods and factors across the provinces. Some economists have suggested that specific constraints should be placed on the ability of the government to tax and to borrow.[7] Essentially, what they have in mind is some limit on the size of government and on the ability of present generations to impose costs on future generations. In a sense, restricting government interference in a market economy to that which promotes the common good is some constraint, though a rather vague one. The issue of future generations is a rather more difficult one. Equity would seem to require that some weight be given to them. One way to do so is to include their rights in the equity statement.

In addition to these general matters of economic concern, there is the additional issue of the assignment of responsibilities in a federal state – i.e., determining the division of powers between the levels of government. The assignment must be consistent with the underlying economic roles of government which are to preserve and foster efficiency in the allocation of the nation's resources and to achieve some degree of equity within the nation, both horizontal and vertical. Given that these objectives are not straightforward to put into operation in a unitary state, they are even less so in a federal state. As explained earlier, the decentralization of responsibilities can itself have effects on national efficiency and equity. In fact, one might think of there being a trade-off between the benefits of decentralization and national efficiency and equity objectives. In a federal context, efficiency includes the full efficiencies of a common market encompassing various regions, including those obtained from the unrestricted and undistorted mobility of labour, capital, goods and services among all regions. Equity requires that like persons be treated in a like manner across the country. Both of these can be compromised by the decentralization of economic responsibilities.

As with the broader question of the resolution of the efficiency-equity trade-off, the ideal amount of decentralization will not be fully agreed upon. One reason is that it is virtually impossible to know the quantitative magnitude of the effects on efficiency from the decentralization of powers. Another is that decentralization typically has both efficiency and equity effects. In particular, the main argument for decentralization is that it improves efficiency. However, it also induces inequities among persons residing in different regions (provinces). Thus one's view of the desired amount of decentralization depends upon the weight attached to equity as opposed to efficiency considerations.

The general arguments for decentralizing expenditure responsibilities are well documented in the fiscal federalism literature.[8] The main ones are summarized as follows:

1 Some of the public goods provided by the public sector are local public goods in the sense that they provide collective benefits to a localized group of persons. Since the preferred amount and type of these goods depend upon the tastes and needs of those who benefit, different provinces will want to provide different amounts of goods. The provinces are in a better position to match their provision with local preferences since the persons who benefit are concentrated in their jurisdiction. This is the conventional argument for the assignment of functions to lower levels of government, but, as we have argued earlier, it is probably of much lesser importance than many of the others.

2 As mentioned earlier, a good proportion of public expenditures is on goods or services which, though essentially private in nature, are nevertheless provided through the public sector for various reasons. Since these services are largely of a private nature, their main beneficiaries are residents in the jurisdiction involved. Decentralization to the provinces may allow the services to be provided in a way which best caters to local tastes. Furthermore, delivery itself may be more efficient at the provincial level since at a higher level administrative costs may rise rapidly. Efficient provision and innovation may also be encouraged because of an element of competition induced among provincial levels of government.

3 There may be purely local preferences for redistribution as well, both as regards the type of redistribution (cash, in-kind, and so on) and the extent. This would also argue in favour of the decentralization of the design and delivery of the public provision of those goods and services which serve a redistributive goal. It might also be used to argue for some independent role of the provinces, perhaps alongside the federal government, to implement their own preferred degrees of redistribution through the tax-transfer system.

4 It has been argued that the decentralization of responsibilities may itself induce fiscal responsibility or accountability since the provision is at a level of government which is "closer" to the people served, and the government faces the discipline of persons leaving a jurisdiction which behaves irresponsibly. The argument for fiscal responsibility may be especially valid to the extent that provinces must finance their expenditures out of their own source revenues.

Against these various benefits of decentralizing expenditure functions must be set those of centralization. A list of them would include the following.

1 If the expenditure is on a public good or service, which simultaneously benefits persons in more than one province, efficiency may be improved by central provision. Examples of this might include expenditures on defence and on the environment. Related to this is the fact that provincial provision, though mainly for the benefit of local residents, may spill over to other provinces. Federal intervention may be important here, though not necessarily federal provision. Examples might include postsecondary education, welfare, and unemployment insurance.

2 There may be economies of scale in providing certain services centrally in cases where the administrative overhead is large.

3 There may be efficiency advantages to having some degree of uniformity or harmonization of some types of services, especially those which may be associated with mobile factors of production. Provincial diversity may interfere with the efficient allocation of resources across provinces. Furthermore, as with taxes on mobile factors of production, provinces may be induced to engage in "beggar-thy-neighbour" policies by using expenditures selectively to attract desirable types of factors, or distract undesirable types (e.g., persons who use a lot of public services for whatever reason).

4 Since many public services are essentially redistributive in nature and derive their ultimate justification for being publicly provided from that fact, national equity suggests some minimum degree of uniformity, at least in the level of provision. This is arguably the most important justification for central intervention, though one which depends critically on one's judgment about the federal responsibility for equity.

In the end, the extent and mixture of decentralized economic functions depend upon the trade-off between the benefits of catering to local tastes, the diversity and perhaps the efficiency of provincial provision versus the possible advantages of scale, the avoidance of wasteful interprovincial competition and spillovers, and the pursuit of national equity standards from central provision.

Given the decentralization of some expenditure responsibilities, some taxing authority should presumably also be decentralized. How much tax responsibility and, in particular, which tax bases should be decentralized depends on one's view of the extent to which one wants to promote national equity and efficiency. Furthermore, the decentralization of taxes itself can be of varying degrees. At one extreme, a tax base can be assigned to the provinces, and they can be independently responsible for tax policy and administration. The tax field may be jointly accessible to the two levels of government and varying degrees of coordination may take place. These range from agreement on the base alone to agreement on both the base and rate structure to common collection machinery. Also, tax rental agreements may allow for central collection with some commitment to turn a share of the proceeds over to the provinces, as is the case in several countries.

As discussed earlier, the decentralization of virtually any tax can give rise to inefficiencies and inequities. Inefficiencies can arise for two main reasons.

1 If provinces levy different tax rates on factors of production which are highly mobile, this will induce an inefficient allocation of those factors across provinces. Since capital is highly mobile, this would suggest that provincial taxes on capital within their jurisdictions (e.g., corporation income taxes) are potentially highly distortionary. Furthermore, provinces may have an incentive to engage in beggar-thy-neighbour tax competition which will work to all the provinces' detriment in the end. Ideally, therefore, such a tax might well be retained at the centre. Taxes on less-mobile factors such as real property and even labour will cause less distortion. The latter includes residence-based taxation such as personal income and payroll taxes, destination-based sales taxes, and user fees and licenses.

2 Related to the above is the fact that fiscal inefficiency is unavoidable as long as tax capacities differ across provinces. Different tax capacities will result in higher tax levels in poorer provinces, and this will provide an incentive for factors to prefer to locate in better-off provinces when on efficiency grounds they should remain in the poor province.

Inequities from decentralized taxation responsibilities can also occur for two main reasons.

1 Different provinces may have different degrees in progression in their tax systems, perhaps due to different local preferences for redistribution. This would imply that otherwise identical persons would face different tax rates in different provinces, thus violating national horizontal equity norms. This would be true even if the tax capacities of the provinces were the same.

2 The fact that they will differ leads to the second source of inequity, one which is closely related to fiscal inefficiency. With different tax capacities, different provinces could provide similar levels of public services with different tax rates. This implies a violation of horizontal equity within the federation since it implies that like persons would be treated differently by the public sector. This fiscal inequity has played an important role in the literature on federal-provincial grants, and we return to it later.[9]

The upshot is that while there may be good reasons for decentralizing some taxing powers to the provinces with which to finance their own expenditures, inefficiencies and inequities are greater the more decentralized the tax system, especially in a nation of heterogeneous provinces. By the same token, central control of a tax field has two possible advantages. One is that it may induce greater harmonization of the tax among federal and provincial governments thereby contributing to the efficiency of the common market and reducing the costs of compliance and administration. The other is that central dominance in a tax field will facilitate its use for redistributive purposes to the extent that it leads to a common base and rate structure. As has been argued elsewhere, these arguments suggest a dominant federal presence in the direct (income) tax fields.[10]

Thus, as with the expenditure side, there is a trade-off between the advantages of centralizing and decentralizing tax responsibilities. The ideal choice of a point on this trade-off may not coincide with that on the expenditure side in the sense that tax collections may differ from expenditure responsibilities. Indeed, we would argue that the arguments for decentralization are much stronger on the expenditure side than on the tax side. Fortunately, in a federal state, it is not necessary for provincial taxes to match exactly their expenditures. In many federations, including the Canadian one, such a fiscal gap exists, and it is filled by federal-provincial transfers. Thus the existence of a system of transfers is a necessary component of a federation in which expenditures are more decentralized than taxes. In fact, there are also other important roles that such transfers play in their own right. Given that, we devote a full chapter to the rationale for transfers later on.

The design of the constitution must take these conflicts between the benefits and costs of decentralization into account and try to devise a compromise which balances the benefits of decentralization with the achievement of national equity and efficiency. Different observers will come to different views about the optimal terms of the compromise. For the sake of concreteness, we present one view as to the appropriate division of powers, taking all the above arguments into account, and making our own judgment about the role of equity in the assignment of powers. We restrict ourselves to outlining how economic responsibilities should be allocated between the federal and provincial levels of government without specifying how these should actually be written into the constitution. For the purposes of this discussion, the federation is taken to be a symmetric one. Obviously, one of the key issues in the Canadian context has to do with whether an asymmetric arrangement is desirable. In a fundamental sense, this involves noneconomic arguments since the asymmetric assignment of economic responsibilities, which presumably involves some province(s) having more decentralized responsibilities than the ideal, is feasible. However, since it involves a compromise of the ideal amount of decentralization, it necessarily involves a compromise of collective economic benefits.

The guiding principles to be used in assigning functions to levels of government are as follows. The federal government should be largely responsible for stabilization, national equity, the provision of public goods and services whose benefits transcend borders, and the maintenance of an efficient and smoothly functioning internal common market in goods and services, labour, and capital. The provinces should be responsible for the provision of services of a local or provincial nature. They should also exercise some shared responsibility for equity with the federal government. The reason for this is partly because the provinces might have differing views about the ideal amount of redistribution within their jurisdictions, but also because many of the fiscal actions of the provinces will have unavoidable effects on equity.

Giving the federal government primary responsibility for nationwide equity is a key component of the preferred division of powers. It is likely to be controversial since it will imply somewhat more centralization of decision making than many observers will like. A fundamental defining characteristic of a nation is that otherwise identical persons ought to be treated the same no matter where they happen to reside, and it is the basic argument supporting this view of equity responsibility. To achieve this even partially requires that the federal government bear some responsibility equity on a national basis.

These principles would suggest the following assignment of expenditure responsibilities. The provinces would be responsible for the delivery of public services which are of a quasi-private nature including health care and insurance, education in all forms (including postsecondary and manpower training), welfare services, family and child support services, provincial transportation and communication services, municipal services, and resource management (including local environmental issues). The federal government, on the other hand, would be responsible for expenditures of a clearly national nature including defence, foreign affairs, international trade, immigration, and so on. To ensure a smoothly functioning common market, those regulatory functions which have effects crossing provincial borders should reside with the federal government, although it is possible to imagine them being affected by quasi-independent bodies which include both federal and provincial representatives. These include the regulation of international and interprovincial trade (in goods and services, including such things as communications and transportation), of environmental issues involving more than one province, agriculture markets, and capital markets. The assignment of labour market regulation should, in principle, also be federal if the objective is to maintain the full integrity of the economic union. Provincial regulation can cause restrictions in the ability of certain types of workers to migrate from one province to another or even to cross borders to work. At the same time, there are presumably some advantages from decentralizing labour market regulations so they can be designed to suit provincial circumstances. If one puts great stress on removing barriers to mobility, centralization of labour market regulations would be favoured. However, the argument is not as strong as in the case of capital and goods since labour is nowhere near as highly mobile across borders as these are. To be effective in the stabilization function, the federal government should assume responsibility for the central bank and the currency.

This assignment of expenditure responsibilities would still be fairly decentralized, especially expenditures on goods and services. However, regulatory functions would be somewhat more centralized, reflecting the fact that many of them involve the regulation of markets for goods, services, and factors which extend beyond provincial borders. Notwithstanding that, it may be that the most effective way for implementing regulatory objectives is through quasi-independent regulatory bodies, which may well have provincial representation. However, that may be more a matter of policy than of constitution making. It seems clear that the federal government must maintain effective responsibility even if they choose to exercise it using such bodies. In other words, federal control can be achieved in ways other than by spending or direct regulation by the government itself.

The assignment of tax responsibilities can be determined independently of the assignment of expenditures, as mentioned previously. The principles of tax assignment are, in fact, more widely agreed upon than those of expenditure assignment.[11] The general consensus in the literature is that the direct (income) tax system should be under the control, or at least the strong influence, of the federal government, though there is no reason why the provinces could not co-occupy the field. Federal dominance assists in the fulfillment of the objectives of national equity. Indeed, it is one of the main instruments the federal government has at its disposal. This will also assist in maintaining a system of income tax harmonization, much as we have in place now. The lower the weight one puts on equity, the more one would be willing to give the provinces independence in designing their own direct tax system alongside the federal one.[12]

From the point of view of economic logic, transfer payments to individuals, unlike government expenditures on goods and services, should be thought of as negative tax liabilities and treated symmetrically with direct taxes. This means they too should be available to the federal government. This includes unemployment insurance, public pensions, family allowances, and welfare payments. The delivery of some of these programs could be delegated to the provinces by agreement, provided the federal government retains some ability to ensure national standards of equity. The federal government could have access to payroll taxes as well since they are complementary with income taxes. On the other hand, since these are not important instruments for equity, there is no reason for federal dominance in the field. More controversially, economic arguments would suggest centralization of corporate taxes and wealth taxes. These are essentially taxes on mobile factors of production whose decentralized use ultimately leads to tax competition and interprovincial barriers to capital mobility. On the other hand, there is no need for federal presence in the indirect tax fields (apart from tariffs, of course), as the Carter Commission noted 25 years ago. They contribute neither to equity nor to tax harmonization and, in fact, can detract from both.[13] Indeed, the more the federal government relies on indirect taxation, the less important will be its role in the direct tax fields, and the less able will it be to pursue the more important tasks of achieving national equity and the harmonization of direct taxes among jurisdictions. These are the most critical objectives of federal tax policy.

This implies that the provinces would assume sole occupancy of indirect (sales) taxes, licenses and fees, property taxes, and would have some access to direct taxes on residents (personal income and payroll taxes) jointly with the federal government. Assuming that the provincial ownership of resources is an immutable fact of life, provinces would also be responsible for resource taxation. Presumably, the provinces will continue to participate in some formal system of direct tax harmonization along the lines of the Income Tax Collection Agreements, though this can only be ensured by a continuing dominant federal presence in the income tax field.

From an economic point of view, it would also be desirable for tax rates to be such that the federal government collects more tax revenues than it needs for its own expenditure purposes. This is partly a consequence of the fact that the desired amount of centralization of taxes exceeds that of expenditures. For example, the federal government needs a large enough presence in the tax field to be able to pursue effective fiscal policy. As well, we have argued that the federal government should maintain enough dominance in direct taxes to be able to achieve tax harmonization and national equity goals. However, the excess of federal tax collections over expenditure responsibilities implies transfers to the provinces, and such transfers have their own independent rationale in a federal economy. We turn to a summary of the reasons for this now.

7 The Economic Rationale for Federal-Provincial Transfers

Some Institutional Background

Federal-provincial transfers have played an important role in the Canadian federation since its inception, and any resolution of the current constitutional impasse must take account of the function they perform in the existing and alternative federal systems. There are a variety of different functions that such transfers fulfill, and there are a variety of different types of transfers which may be said to exist for the purpose of fulfilling those functions. Each major type of transfer contributes to a variety of objectives, and each objective is served by a variety of transfers. Therefore, it is necessary, when evaluating individual components of the system of transfers, to consider them in the context of the system of federal-provincial fiscal arrangements as a whole. That will be the purpose of this chapter.

The system as it has evolved has four main components. First, there is the system of Equalization payments which disburses funds to the so-called "have-not" provinces according to their "tax capacity." Second, there is the large component of essentially equal per-capita transfers to all provinces under the EPF system. Third, there are the income tax revenues collected on behalf of most provinces by the federal government and returned to their province of origin under the Tax Collection Agreements. Fourth, there are the various conditional grant programs whose magnitudes are related to amounts spent within the recipient provinces. By far the most important of these are the transfers under the CAP.

Three main underlying elements have characterized the system of grants in Canada, jointly reflecting the unique nature of fiscal federalism in the Canadian institutional context. The first of these elements is the *concept of equalization* – i.e., the notion that federal government transfers to the provinces should be relatively more generous to the less well-off provinces. This principle has been applied in a variety of ways using various instruments, but it has been continuously present in one form or another since Confederation. So established is it as a principle that it has been included explicitly as a commitment of government policy in Section 36(2) of the Constitution Act of 1982.

The second long-standing element of federal-provincial fiscal arrangements has been *the use of tax sharing and tax coordination of co-occupied tax fields*. These are related to federal-provincial transfers since the tax-sharing methods have typically involved the federal government collecting tax revenues on behalf of the provinces and turning the funds back to the provinces according to some allocation rule. Tax-sharing regimes have been seen as devices for coordinating tax bases among the governments at both levels and thereby contributing to the free flow of goods and services within the federation. Tax sharing has also been seen as a device for minimizing inefficient tax competition among provinces, reflecting the greater economic ability of the federal government to raise revenues as compared with their expenditure responsibilities relative to the provinces.

The third element of federal-provincial fiscal arrangements has been *the attaching to grants of conditions on the use of transferred funds*. The use of conditions has frequently been accompanied by financial incentives for the provinces which makes the exact amount of the federal transfer dependent on amounts spent by the provinces. Such incentives have included both positive incentives, such as matching contributions, and negative incentives, such as reductions in federal contributions in the absence of provincial spending of a particular sort.

All three of these key elements, equalization of overall transfers, the use of tax sharing, and conditionality, have been characteristic of federal-provincial fiscal arrangements for a long time and continue to be so today. To see this, it is useful to begin with a brief review of the key elements of the system as it exists today.

Equalization

The Equalization scheme is a system of transfers financed from federal government general revenues and allocated as unconditional transfers to the "have-not" provinces under the Federal-Provincial Fiscal Arrangements Act. It transfers moneys to those provinces whose tax capacity (defined for the purposes of Equalization as the amount of tax revenues per capita that would be generated by applying national average tax rates to a common set of representative provincial tax bases) is below the average for five provinces (Ontario, Quebec, Manitoba, Saskatchewan, and British Columbia). The have-not provinces are those which are below this average, and the amount transferred is that required to bring each have-not province up to the five-province average.

The intent of the scheme as seen by economists is to help the provinces provide comparable levels of public services at comparable tax rates [see, for example, Graham 1964; Boadway and Flatters 1982; and Economic Council 1982]. However, it does not achieve this goal completely. Three important reasons why it does not are as follows. First, while the scheme moves have-not provinces up towards the five-province average, it does not move wealthier provinces down, except indirectly, to the extent that federal tax revenues used to finance the scheme tend to be drawn more from the latter. Second, since a five-province standard is used rather than a national-average standard (which was used for several years before 1982), the standard to which the provinces are being equalized is not the national average. In particular, since Alberta is left out of the standard, the very important oil and gas revenues are effectively omitted from the standard and that lowers the tax capacity of the standard. Against this is the fact that the least well-off provinces are also left out of the standard. According to officials in the Department of Finance, Equalization is currently to the level of 98 per cent of the national average. Third, Equalization operates through the tax-capacity side and does nothing to equalize differences in the ability of provinces to provide comparable public services arising from such things as differences in the need for, or the cost of provision of, various public services.

Established Programs Financing

The Established Programs Financing (EPF) transfers are made from federal general revenues to the provinces based on a block-funding formula. The transfers, which began in 1977 with the EPF Act, are in respect of provincial health and postsecondary education programs. Prior to the EPF Act, health-care grants were made separately under the Hospital Insurance and Diagnostic Services Act of 1957, and the Medical Care Act of 1966 and were tied to the costs of the programs in the provinces. Similarly, transfers for postsecondary education were made under the previous Federal-Provincial Fiscal Arrangements Act and were also related to overall provincial expenditures in that area. With the EPF Act, contributions for health care and postsecondary education were brought together under one Act, and they were changed from a shared-cost basis to a block-funding basis under which they were no longer tied to provincial program expenditures.

Federal EPF transfers to the provinces are calculated on an equal per-capita basis. The magnitude of the transfer is determined by two factors. First, the level at which the transfers were first introduced in 1977 was set at the level of per-capita national average transfers made under the previous cost-sharing arrangements that existed for health and postsecondary education in 1975-76, plus the equivalent of two tax points (to compensate for the loss of the so-called revenue guarantee from the 1972 tax reform). Second, the per-capita transfers were to rise each year at the rate of growth of per-capita nominal GNP (according to a moving-average formula). There have been some exceptions to this rate of increase. One was due to the elimination of the value of the two tax points which compensated for the revenue guarantee in 1982. Another was due to the temporary application of the "6 and 5" guidelines to the postsecondary education component under which that component increased by 6 per cent in 1984 and 5 per cent in 1985. Next, the federal budget of April 1989 announced that the rate of increase will be reduced permanently by 1 percentage point beginning in fiscal year 1990-91. The two most recent budgets (1990 and 1991) have frozen the per-capita EPF allotments. A consequence of these restrictions, all of which have applied to the cash-grant component, is that the latter will be eliminated in the near future.

The federal contribution is made by a combination of tax transfers and cash payments. The tax transfer consists of a reduction in federal income tax rates so that the provinces can increase theirs by the same amount with no consequences for the taxpayer. The amount of the tax transfer is 13.5 personal income tax points (or 13.5 per cent of the basic federal income tax) and 1 corporate tax point (or 1 per cent of the federal corporate taxable income).[1] For all but Quebec, the value of these tax points along with the associated Equalization adjustment arising from them is deducted from the EPF entitlement. The remainder is paid to the province out of the Consolidated Revenue Account. Quebec residents receive, in addition to the tax points, a personal income tax abatement of 8.5 per cent in lieu of part of the cash payment. This reflects the fact that Quebec had opted out of certain shared-cost programs in the 1960s.

The combination of equalized tax points and cash payments ensures that each province is entitled to receive an equal per-capita transfer under the EPF Act, at least until the cash component disappears. The value of the total transfer is nominally allocated between insured health services and postsecondary education in the approximate proportions of 67.9 and 32.1 per cent, respectively; but this is of no consequence for the use of the funds. These figures are based on the nationwide proportions of health and postsecondary education expenditures in 1977 and have no particular significance today. There is also an additional cash transfer for extended health-care services which was $20 per capita in 1977-78 and is escalated annually at the same rate as insured health services.

To qualify for full payment of the cash component for insured health services under the EPF Act, provinces must satisfy certain criteria set out in the Canada Health Act of 1983, Sections 7-12. This Act repealed the Hospital Insurance and Diagnostic Services Act and the Medical Care Act, which stipulated very similar criteria. The criteria state that the provincial health-insurance plans must be characterized by: a) public administration, b) comprehensiveness, c) universality, d) portability, and e) accessibility, each of which is defined in the Act. In the event that these criteria are not satisfied and after consultation with the province, the cash contribution can be reduced in whole or in part depending on the gravity of the default (Section 15). This penalty provision has never been applied under this Act or the ones it repealed.

In addition, in those provinces in which either extra-billing by medical practitioners or dentists occurs, or in which user charges are levied, the cash contribution is reduced by an amount equal to the total amount of extra-billing and user charges paid within the province (Sections 18-20). As mentioned earlier, a similar provision applied under the Hospital Insurance and Diagnostic Services Act.

There are several features of EPF transfers which are relevant from an economics point of view. Despite the fact that the grants are notionally divided into health and postsecondary education components, the grants are otherwise unconditional except for those criteria listed in the Canada Health Act as discussed above – i.e., the total amounts transferred bear no direct relation to the amounts actually spent. The escalation rate is different from the rate of growth of postsecondary education and health spending by the provinces (which may differ across the provinces), and the notional division between the components need bear no relation to the proportions in which the funds are spent by the provinces. Thus there is no matching financial incentive provided to the provinces to change the size or allocation of their spending on health and postsecondary education or of the allocation of spending within these categories as there was prior to 1977.

The main effective conditions attached to the use of the funds are through the incentives applied by the Canada Health Act. The dollar-for-dollar reduction for any moneys collected within a province through extra-billing or user charges does not preclude provinces from engaging in these practices, but they incur a financial cost if they do so. There is, as well, the ultimate sanction of withholding a portion of EPF cash transfers entirely if a province does not maintain a health-insurance system which is universal, portable, accessible, comprehensive, and publicly administered, though this sanction has never been applied, and it is not clear what circumstances would induce its application.

The other aspect of EPF transfers, one which makes them complementary with Equalization, is that they are implicitly redistributive across the provinces. The combination of financing from general revenues and disbursing equal per-capita payments to all provinces means that, on balance, EPF has as its ultimate effect the redistributing of revenues from high-income to low-income provinces. From an economic point of view, EPF is as effective an equalization scheme as Equalization itself.[2]

While Equalization is sometimes seen as a scheme which redistributes revenues horizontally across the provinces according to the relative tax capacities of the provinces, EPF may be viewed as a scheme for redistributing tax revenues vertically between the federal and provincial levels of government. The federal government selects its tax rates so as to generate enough revenues to finance its own expenditures as well as to finance its transfers to provinces. In turn, the transfers received by the provinces reduce their revenue requirements so they can choose lower tax rates than they might otherwise have done. The overall effect of the existence of these transfers is for the federal government to levy relatively more taxes (occupy more *tax room*) and the provinces relatively less than would be the case in the absence of the transfers.

To summarize, the financial consequences of EPF are threefold. First, the existence of EPF implies that the federal government occupies relatively more of the tax room, and the provinces as a whole correspondingly less than might otherwise be the case. This has consequences for the ability of the federal government to maintain a harmonized direct tax system. Second, though, the consequences for individual provinces differ across the provinces because of the fact that the EPF scheme is implicitly redistributive – i.e., it is part of the equalization system broadly defined. Third, the cash transfer component enables the federal government to exercise its spending power to provide incentives for the provinces to implement provincial programs in accordance with federal desires.

The Tax Collection Agreements

The Tax Collection Agreements are relevant for our discussion as an alternative institutional vehicle by which revenues can be reallocated between the federal and provincial governments. Under the Tax Collection Agreements, the federal government collects personal and/or corporate tax revenues on behalf of the provinces and passes on to the provinces their share of the tax proceeds according to the amounts collected in each. To be party to the Agreements, the province must accept the same tax base as the federal government, but each province has the right to set its own tax rates and to establish a system of nondiscriminatory credits. In return, the federal government collects taxes free of charge for the provinces and administers credits for a small fee.

The tax bases covered by the Tax Collection Agreements are co-occupied by the federal and provincial governments. The total tax rate applied to those bases must somehow be divided between the federal and provincial governments – i.e., the division of the tax room must be determined. This is effectively accomplished by the joint choice of tax rates by the two levels of government. Given the federal government's tax rate, the provinces can set their own rate (and vice versa). However, the larger the federal tax rate, the less tax room there is for the province. Thus the relative amounts of funds available to the federal and provincial governments are partly determined by the division of the income tax room. One reason the federal government can maintain a sizable level of grants to the provinces is because of the amount of tax room it occupies relative to the provinces.

However, the tax mix is also important. The federal government can finance a given amount of transfers to the provinces by differing mixes of taxes, especially direct versus indirect. The larger the proportion of federal reliance on indirect taxes (i.e., the GST), the less the direct tax room the federal government has to occupy. This is important to the extent that occupancy of direct tax room by the federal government is important. We have argued that it is important for two reasons – to maintain a harmonized income tax system and to pursue national equity objectives.

Equivalently, an alternative way of getting money to the provinces, rather than through, say, equal per-capita EPF transfers, would be by making more tax room available to the provinces (i.e., by transferring tax points). To accomplish this, the federal government could simultaneously reduce EPF transfers and its own tax rate, so the provinces could choose to make up their lost EPF revenues by increasing their own tax rates. Such a change might appear to reduce the redistributive element of the EPF transfer since under the EPF grant the provinces receive equal amounts per capita, while under the tax-point transfer they receive additional revenues according to the amount raised in their own jurisdiction.[3] However, that difference is more apparent than real. Since these tax points are normally equalized, the transferring of tax revenues through tax points is not as different from the per-capita transfers through EPF as one might imagine. It is not exactly identical since the equalizing of tax points effectively only raises the revenues of the have-not provinces and does not lower those of the have provinces. Therefore, the combination of federal occupation of tax room and the use of that tax room for equal per-capita transfers to the provinces via EPF contribute to the goal of equalizing the ability of provinces to provide comparable levels of public services at comparable tax rates – i.e., it fulfills a type of equalization not fully achieved by the Equalization scheme itself.

Conditional Grant Programs

The federal government administers a large number of conditional grants to the provinces which are tied to specific uses by the provinces and which may or may not be matching.[4] The grants provided under the Canada Assistance Plan Act of 1966 are by far the most dominant. The CAP is a matching conditional grant program under which the federal government transfers to each province one half of the costs of eligible social assistance and social services expenditures. Eligible social assistance expenditures include transfer payments made to the needy in the form of provincially or locally administered welfare assistance. Eligible social service expenditures include operating costs in excess of those for 1964-65 incurred in providing various social services to needy persons. The CAP is distinguished from the other grants in being both conditional and matching. The conditional aspect restricts the use of the transfers for particular purposes, while the matching aspect provides a financial incentive for provinces to increase their spending. A dollar's worth of spending "costs" the province only 50 cents. Thus the design of the scheme provides a financial incentive not only for the establishment of provincial programs of social welfare, but also the amounts spent. But provinces retain the discretion to choose their own levels of spending. The conditions set and the financial incentives provided by CAP have not prevented the provinces from exercising considerable discretion over the amounts they spend on welfare. As documented in McMillan [1991], spending per capita on welfare varies significantly among provinces, and therefore so do CAP grants received.

Given this brief institutional background, we now discuss the economic reasons for transfers.

Economic Arguments for Federal-Provincial Transfers

In the economics literature, one can distinguish four broad economic reasons for transfers of funds from the federal government to the provinces. All of these are based on the fundamental criteria that economists conventionally use to prescribe and evaluate policy – efficiency and equity. The rationale for federal-provincial transfers comes from applying these widely accepted criteria to a federal economy. Consider each in turn.

Fiscal Gap

The existence of federal-provincial transfers implies that the federal government is collecting more taxes than it needs to finance its own expenditures, and the provinces are collecting correspondingly less. To the extent that this shortfall of the provinces' revenues to finance desired provincial expenditures reflects a structural imbalance, it is referred to as a fiscal gap.

There are two possible reasons for this imbalance to exist. One is that the federal government has relatively easier access to revenue sources than the provinces, and so it is efficient for it to collect revenues on the provinces' behalf in order to allow the provinces to carry out their large responsibilities, especially in the areas of health, education, and welfare. This differential ability to raise revenues, if it exists, is not due to constitutional limitations on the access to revenue sources (which seem ample), but to a reluctance by provinces acting independently to raise tax rates or broaden tax bases for fear of losing labour, capital, or business activity. This is referred to as tax competition. If grants did not accommodate this fiscal gap, it is argued that the reluctance of provinces to raise their own tax revenues would result in a level of public services that was lower than what the residents collectively desire. In particular, competition to attract labour, capital, or business activity may induce all provinces to set their tax rates too low, and thus raise too little revenue relative to what would be efficient.[5] If a gap exists because of tax competition, the appropriate remedy is for the federal government to collect more taxes than it needs and transfer the excess to the provinces. The types of transfers the federal government chooses and their allocation across the provinces depend very much on the other reasons for grants listed in Fiscal Inequity.

Not all economists would agree that a fiscal gap in the above sense exists. It would be difficult, if not impossible, to devise an empirical test that would indicate whether or not tax competition reduces the relative ability of provinces to raise their own tax revenues.[6] An alternative hypothesis is that the fiscal gap is determined essentially by the amount of tax room the federal government has historically claimed for itself rather than any fundamental structural imbalance between provincial revenue-raising ability and expenditure responsibility. The major tax sources are co-occupied by the federal and provincial governments, including the income tax fields which are subject to the Tax Collection Agreements and, now, the retail sales tax field. The tax rates that the federal government applies to these fields are such that they are able to finance both their own expenditures and their grants to the provinces. If the fiscal gap is not structurally determined, its existence is simply a reflection of the fact that the federal government has chosen to make transfers to the provinces for the reasons to which we now turn.

Fiscal Inequity

The argument for grants based on fiscal inequity is a fundamental one both for equalization and for other transfers which redistribute income among provinces. It forms the economic basis for the constitutional prescription that the federal government "ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation" (Section 36(2) of the Constitution Act of 1982). The argument is as follows. As we have already seen earlier, in a federal system of government in which the provinces are left to finance their public expenditures from their own tax sources, different provinces will inevitably be able to provide different NFBs to their citizens in the absence of federal-provincial transfers. These differences can arise for a variety of reasons including: differences in access to producer-based taxes such as resource revenues; differences in access to income tax and sales tax revenues when per-capita incomes differ and when tax liabilities are related to incomes; differences in the cost of providing public services because of geographical factors, different wage rates, different climates, and so on; and differences in the need for public spending due to different proportions of old persons and dependents, different health characteristics, and so on.

The existence of differential NFBs across the provinces gives rise to horizontal inequities. A fiscal system is horizontally inequitable if two persons, otherwise identical, are treated unequally by the tax and expenditure system. In the case of a federal system of government with provinces offering different NFBs per capita, otherwise identical persons residing in different provinces will be treated differently by the federal fiscal system. They will receive different NFBs from their respective provincial governments, and these differences will not be recognized by the federal tax system.

The ideal remedy for this situation of horizontal inequity, as outlined by the Economic Council of Canada [1982], is to eliminate these inequities by a system of redistribution of revenues across the provinces.[7] The complete elimination would involve a set of transfers which compensated both for differences in tax capacities and for differences in the need for, and cost of, providing provincial public services. This ideal could be achieved by a set of purely redistributive transfers which redistribute funds from provinces with above-average NFBs to those below the average. As was argued in Economic Council of Canada [1982] and Boadway and Flatters [1982], if it is assumed that the benefits of provincial public expenditures are roughly equal per capita and tax liabilities for residence-based taxes are roughly proportional to income, equalizing fully the NFB differentials from tax capacity differences would involve equalizing all the provinces' tax capacities to the national average standard (both up and down). Alternatively, the federal government could raise all tax revenues on behalf of the provinces and transfer them to the provinces in a way which allows each province to provide the same level of provincial NFBs (as was roughly the case at the time of Confederation and during the Wartime Tax Rental Agreements). In the absence of need and cost differences, this would involve equal per-capita transfers.

Neither of these ideal remedies is available in the Canadian federal system. The purely redistributive scheme would involve transfers purely among the provinces, whereas, in Canada, transfers are financed out of federal general revenues. At the same time, the federal government no longer goes to the other extreme of collecting all revenues on behalf of the provinces. The provinces continue to raise some revenues on their own behalf so that NFBs are not completely eliminated. In addition, need and cost differences pose a problem. They are rather difficult to measure in the abstract and will typically only be reflected in the levels of provincial public expenditures of various sorts undertaken. If the federal government wished to make transfers contingent on levels of cost or need, they may have no other way of doing so than basing the transfers on actual provincial expenditures in a particular area – i.e., making the grants matching. This constitutes an equity argument for including a matching component in specific-purpose federal-provincial grants which goes along with the spillover argument discussed in the next section. The problem with matching is that it also has incentive effects on the province which induce it to increase spending. While this may be desired for spillover correction, it is not called for on equity grounds. That is why we have suggested elsewhere in this study that cost and need might be taken into account using an equalization-type approach whereby the transfer is based on an index of need in the same way as Equalization uses the representative average tax base and rate approach.

Fiscal Inefficiency

The argument for eliminating NFBs using a system of grants is further strengthened by recalling that NFB differentials can also give rise to inefficiencies in the allocation of resources across the provinces. In particular, differences in NFBs between any two provinces provide an economic incentive for persons to choose to reside in the province with higher NFBs. Since this differential does not reflect differences in labour productivity across the provinces, the upshot of such "fiscally induced migration" is that labour is allocated across the provinces in an inefficient way – i.e., in a way which does not maximize the value of national output. Relatively too much labour is allocated to the provinces with higher NFBs.

This possibility of fiscal inefficiency resulting from differences in per-capita NFBs across the provinces provides further support to the case for using grants to eliminate, or at least reduce, these differentials. The same structure of grants would be called for as on equity grounds. The elimination of these differences enhances the role of labour mobility in inducing an efficient allocation of labour across the provinces.

Interprovincial Spillovers

The final category of argument for grants, and the one which on the surface provides the most direct argument for conditionality of grants, concerns the fact that the benefits of certain public expenditures of one province may spill over to other provinces. There are various ways in which this may occur, and it is useful to categorize them into two conventional types. The spillovers can arise due to interprovincial externalities or due to the influence of provincial expenditure programs on the flows of goods and factors across the provinces – i.e., on the gains from trade from the internal common market. Consider each briefly in turn.

Interprovincial externalities

Interprovincial externalities exist if the benefits from one province's spending accrue not only to that province's residents but also the residents of another province. There are several examples that might come to mind. The highways in one province are used by the residents of other provinces for the movement of goods and services and factors of production. The postsecondary education system of one province benefits other provinces both because residents of one province might attend university in another province or because the knowledge produced by the university is freely available to all. The welfare system of one province benefits the residents of another for a variety of reasons. It provides an incentive for welfare recipients to reside in the province offering welfare rather than moving to another. It provides a way of assisting poor persons and that may appeal to the altruistic urges of all persons, regardless of where they live. It may reduce the incentive for a province to exploit the unemployment insurance system which is partly financed by the residents of all provinces. Somewhat similar arguments could be made of a publicly provided health-care system which is universally accessible, comprehensive, and portable.

Whenever interprovincial external benefits exist, provincial governments do not have the proper incentive to provide the correct levels of services which yield these spillover benefits. In particular, in deciding on service levels, their incentives are to weigh the costs of provision against the benefits of their own residents, neglecting the benefits of other provinces' residents, and this will result in too low a level of provision. If these spillovers arise in a reciprocal fashion from all provinces' expenditures on these items, all provinces will underprovide and everyone would be better off if the provision were to increase. One way to provide the provinces with such an incentive is by a system of matching federal-provincial grants. The matching aspect makes it cheaper for the province to undertake spending in the area, thus providing a financial incentive. By their very nature, these external benefits are difficult to measure since they are not reflected in any market price. Therefore, their implementation requires some political judgment.

A related phenomenon occurs for those provincial public services which serve partly a redistributive objective. As we have argued, many provincial public services are implicitly redistributive in the sense that they provide more services to those less well off than the latter would be able to obtain if they paid the full cost. Such services are said to provide "in-kind redistribution." To the extent that the federal government is interested in redistribution as a goal, there is a national interest in redistribution that occurs via the provision of public services as well as via progressive taxes and transfers. Since many of the programs that incorporate in-kind redistribution are at the provincial level of expenditure responsibility, the federal government may be restricted to assisting the provinces financially in the provision of these programs, at least to the extent that they fulfill the redistributive goals (or other goals of national interest).

Common market arguments

This argument rests on the notion that there is an advantage to the nation as a whole from harmonizing public expenditure programs since uniform expenditure programs will contribute to the free flow of goods and services, labour, and capital and will therefore improve the gains from trade from the internal common market. Such uniformity, as well as portability, might be particularly useful in such areas as health, education, and welfare as ways of encouraging the unimpeded free flow of labour among provinces. Expenditure harmonization in other areas would be useful for ensuring freedom in the movements of goods and capital (e.g., transportation, resource development, and so on).

One of the ways in which expenditure harmonization can be induced is through grants-in-aid which are conditional on program design. In choosing such policies, there will always be a trade-off between uniformity, which encourages the free flow of goods and factors, and decentralization which may encourage innovation, efficiency, and accountability. Of course, the decentralized public provision of goods and services may itself tend to have a certain degree of uniformity. As with tax competition, there may be competition on the expenditure side which induces localities to replicate programs that are being offered elsewhere. On the other hand, the expenditure programs thus achieved may, because of the competition, not conform with what is judged to be optimal (i.e., efficient and equitable) from a national point of view.

The Existing System of Transfers in Light of the Economic Arguments

We are now in a position to relate the major components of the federal-provincial transfer system to the economic justification for grants as outlined previously.

Equalization

The economic objective and effect of the Equalization system is to correct for differences in NFBs across the provinces, or to use an equivalent terminology, to move the provinces in the direction of being able to provide reasonably comparable public services at reasonably comparable levels of taxation. It does this by providing grants to the have-not provinces to bring their tax capacities up to the standards of the five provinces in the formula. However, by itself the Equalization scheme only partially achieves the economic objective. This is partly due to the design of the system, but partly also due to the inherent difficulty in incorporating such things as need and cost fully into the formula. There are several ways in which the system falls short of fully eliminating all fiscal benefit differentials, some of which are compensated for by the design of complementary programs, including CAP and EPF.

a) The transfers are based solely on differences in tax capacities across the provinces. They do not incorporate any elements of need or cost differences in the provision of provincial public services. Some countries (e.g., India and Australia) do attempt to incorporate such differences into their redistributive grants, difficult though it might be to do so exactly.

b) The system equalizes the have-not provinces up, but does not equalize the have provinces down – i.e., the system is a gross one, not a net one. It is financed by federal general revenues rather than by payments from the have provinces alone. As long as the have provinces retain their superior tax capacities, it is not possible to achieve completely the goal of all provinces being able to make comparable public expenditures at comparable levels of taxation.

c) The standard to which the tax capacities of the have-not provinces are raised is not the national average standard based on all revenue sources. Instead, it is a five-province standard which, by excluding Alberta, effectively excludes the immensely important oil and gas revenues. Indeed, the absence of Alberta means that, while the oil and gas revenues of that province are not equalized across other provinces, the oil and gas revenues obtained by the have-not provinces (e.g., Newfoundland and Nova Scotia) are fully equalized down.

d) Those natural resources whose revenues are equalized do not enter into the formula in an economically ideal way. Equalization payments are based on national average rates applied to a base consisting of the value of the resource with no account taken of differences in the cost of extracting the resource from different sources. The consequence is that potential rents are not equalized. Also, some natural resource rents go unequalized because of the way they are passed on to residents. This is especially true for those resources whose rents are largely dissipated to consumers and the private sector through low prices, such as timber and hydro-electricity.

e) The equalization of personal income taxes takes no account of persons in a negative taxable income position – i.e., those receiving net transfers rather than paying taxes. The ability of provinces to redistribute income ought to take account of such persons. One way to do so, as suggested by the Parliamentary Task Force on Federal-Provincial Fiscal Arrangements [1981] is to allow transfer payments to enter negatively into the Equalization formula. The existing system takes no account of the relative numbers of persons in nontaxpaying positions so does not ensure that different provinces can provide comparable levels of public services with comparable levels of taxation.

The upshot of these shortcomings is that the formal Equalization system by itself is not adequate to the economic task of eliminating NFBs or, equivalently, to the desire for the federal government to make equalization payments to ensure that all provinces can provide reasonably comparable levels of public services at reasonably comparable levels of taxation. Evidently, the Equalization system *per se* must be supplemented by equalizing payments of alternative sorts.

Established Programs Financing

One program which complements Equalization payments and makes equalization more comprehensive is EPF. One way to look at EPF is as a scheme whereby the federal government raises revenues, through its own tax sources and transfers the revenues to the provinces in equal per-capita amounts. Even if federal tax revenues are only proportional to income overall, the scheme will be redistributive in the sense of transferring revenues to low-income from high-income provinces. In other words, EPF is part of the equalization system in the broader sense. As mentioned earlier, an EPF-type system could be relied on entirely for equalizing the tax capacities of the provinces if the federal government levied all taxes and distributed them to the provinces on equal per-capita terms.

Of course, the EPF system does not go that far. Nonetheless, it does complement the existing system in a couple of ways. Unlike the Equalization system, which makes payments to the have-not provinces, but does not extract negative entitlements from the have provinces, EPF treats all provinces symmetrically by implicitly equalizing the have provinces down and the have-not provinces up. It also takes account of the fact that different provinces have differing proportions of persons in a nontaxpaying position. However, it also shares some of the drawbacks of the Equalization system. It operates solely by redistributing revenues from high- to low-income provinces so it takes no account of need or cost differences on the expenditure side. Also, since EPF, like Equalization, is financed from federal revenue sources, it does not equalize differences in tax capacities of purely provincial revenue sources. This is especially important for the case of resource revenues, although the federal government has in recent years negotiated some access to oil and gas revenues through the bilateral revenue-sharing and pricing agreements with producing provinces.

Thus the overall redistributive structure of EPF grants can be justified as a component of the equalization system complementing the formal Equalization system. As well, the principle of the federal government raising more revenue than it needs and transferring the excess to the provinces might be justified in terms of the so-called fiscal gap if tax competition would preclude provinces from raising enough tax revenues to finance the desired level of provincial expenditures on their own purely through their own tax instruments.

However, there is more to the EPF structure than a simple system of redistributive transfers. Nominally, the funds disbursed under EPF are divided into those intended for provincial health expenditures and those for postsecondary education. Apart from the possible penalties imposed under the Canada Health Act to which we return later on, the EPF grants in fact are very much like unconditional transfers. The amounts transferred bear no direct relation to spending by individual provinces in these areas since they are neither matching nor do they grow at the rate of growth of health and postsecondary education expenditures. On the other hand, they are not completely free of conditions since technically the provinces are required to maintain health-care systems which satisfy certain conditions. Thus the federal government could withhold the health part of the cash grant entirely if a province chose to disband its medicare system.

Although it seems reasonable to view the postsecondary education component of EPF to be unconditional, the health component contains elements which are, at least potentially, conditional. Let us consider the conditions imposed in more detail. This will serve as a case study of the sorts of arguments that might be made for the use of the spending power.

The issue to be addressed is: Why attach conditions to the receipt of the health-care component of the EPF cash grant? We begin by presenting some general arguments for conditional grants-in-aid of health expenditures, and then turn to considering the specific sorts of conditions imposed under the Canada Health Act (and its predecessors). It should be made clear at the outset that our main concern is not with the question of whether health insurance should be provided by the public sector rather than the private sector. That is not really at issue here. The decision whether or not to provide public health insurance is a different one than the question of which level of government should provide it or finance it. The argument for federal grants presumes that the provision of health insurance is a legitimate role for the public sector. Given that it is and that the provinces are presumed to have the responsibility for providing it, what are the economic arguments for federal conditional grants-in-aid which presumably give a financial incentive to the provinces to choose to satisfy the conditions?

Drawing on our discussion of the role of federal-provincial grants from the previous section, at least four general arguments can be suggested in support of attaching conditions to health-care grants.

Redistributive equity — Federal (as well as provincial) economic policy is ultimately aimed at the goals of economic efficiency and equity. The pursuit of equity can involve both income redistribution through the system of progressive taxes and transfers and in-kind redistribution by the provision of specific services and goods to less well-off persons. Health care (along with, say, education, housing, and so on) can be viewed as a vehicle for in-kind redistribution. To the extent that redistributive equity is as much a concern of the federal government as of the provinces, the use of federal grants to assist and encourage the provinces to undertake this form of redistribution might be argued to be a reasonable policy on economic grounds. This is basically the manner in which an economist would justify Section 36(1) in the Constitution Act of 1982, which commits both levels of government to promoting equal opportunities for the well-being of Canadians and providing essential public services of reasonable quality to all Canadians.

Equalization — A related but quite separate case can be made on the grounds of fiscal equity and efficiency. It was argued above that horizontal equity among persons in different provinces can be achieved only if all the provinces have enough revenues to provide comparable levels of public services at comparable rates of taxation. Equalizing tax capacities alone will not ensure that this will be the case since differences in need and cost of provision will imply that comparable levels of public services can only be maintained with appropriately differing levels of provincial expenditure. If one views health care as a public service, conditional grants-in-aid of health can be justified. Some commentators would go as far as suggesting that health care is an *essential public service* and that *a minimum national standard* of provision is required [see Johnson 1985]. Grants might be a useful way of enabling provinces to meet this standard, though in this case the size of the grant should be related to the need and cost of the service concerned.

Interprovincial competition — In setting their taxes and expenditures, provinces may be concerned about losing factors of production to other provinces. If all the provinces share the same concern, the end result is predicted to be levels of taxes and provision of particular public services which are too low relative to what would be justified if all acted cooperatively or in concert. It is easy to imagine this happening in the case of health-care provision. It may or may not have been the case that, if no conditional grants had existed, provinces would have instituted their own schemes eventually. But, there are economic reasons why not all might have done so despite the fact that it may be in the public interest of the citizens of all provinces collectively to do so. One reason is that the institution of such a plan requires a substantial increase in tax revenue requirements. A province acting independently may be reluctant to introduce such a large increase in tax rates not knowing whether other provinces will follow suit. There may be enough perceived tax competition for the province to fear that such a rise in taxes would cause a loss in labour, capital, or businesses to other provinces. On the other hand, if each province were reasonably sure that other provinces would follow suit, it would be much less reluctant to raise tax revenues to finance the introduction of health insurance. The existence of conditional grants is one way of providing some assurance that all the provinces would follow suit. Another reason for a province's reluctance to act independently to introduce health insurance is a fear of what may happen to medical professionals within the province who may be opposed to it. Since these professionals are reasonably mobile, if only one province were to introduce health insurance, the objection of the medical community could result in out-migration from the province. It could also make such a program difficult to administer. Thus, given that the provinces must, for noneconomic reasons, be the government level which legislates and administers public health insurance schemes, the only lever the federal government may have to exploit the collective gains from health insurance is financial.

Labour mobility — For a well-functioning common market, such as one would like a federal economic system to have, it is desirable that no artificial incentives be set up for discouraging labour from living in one province rather than another, or for discouraging persons from working or visiting other provinces temporarily. The existence of a uniform accessible system of public health insurance removes a potential source of differences in public services which could distort the allocation of labour across the provinces – i.e., provinces might otherwise compete in health services to attract desirable types of workers and to discourage others. Ensuring that provinces have both the financial ability and the incentive to maintain public health insurance schemes assists in the smooth functioning of an unimpaired labour market. On the other hand, from an empirical point of view, this may be a relatively small effect. And, if the differences in health-care systems that provinces want to implement reflect differences in preferences rather than strategic behaviour, it would be sensible to have a system flexible enough to allow such differences to persist.

The previous four arguments constitute the main rationale for the federal government imposing conditions and financial incentives on the full receipt of the EPF entitlement for health care. The Canada Health Act imposes rather specific conditions and penalties. Let us consider each of the five specific criteria stipulated under the Canada Health Act and the deductions for revenues obtained from extra-billing and user fees in light of these arguments. We attempt to show how each might be related to the economic arguments for the spending power. In the end, one will have to make a judgment as to whether the conditions are justified.

Public administration — This criterion requires that the provincial health-care insurance plan be administered and operated on a nonprofit basis by a public authority responsible to the provincial government and subject to audit of its accounts and financial transactions. The desirability of public administration in this sense may be related to the economic arguments outlined earlier. If the health insurance program is to be viewed partly as a public service and partly as a vehicle for redistributive policy (equity), then it cannot be operated on a profit-seeking basis. It is natural, therefore, to wish the administration to be done by a public authority. In addition, public administration can be justified on the grounds of improving accountability and assuring access to the data required for the operation of the grant scheme. It can also be argued that publicly administered insurance schemes are less costly to operate because of lower overheads, economies of scale in operating costs, and an absence of wasteful expenditures on advertising and other costs of private-sector competition.[8] Thus requiring public administration as a condition of full receipt of federal funding is justified as a means of helping to ensure that national distributional objectives are pursued and that funds are used in the least-cost manner.

Comprehensiveness — This criterion is satisfied if the health-care insurance plan insures all health services provided by hospitals, medical practitioners, or dentists. Additional services provided by other health-care practitioners may also be insured at the province's discretion; and many provinces do, in fact, insure services other than those required to satisfy the criteria. Here again the redistributive argument is relevant. If one views health services as a suitable vehicle for in-kind redistribution, it would seem sensible, as a minimum, to include all basic health services as being available on the same terms. The other general arguments are relevant here as well. Requiring that comprehensive services be provided in order to be eligible for the full EPF grant removes an incentive provinces might have to cut services as a consequence of competing with other provinces to lower taxes or to attract health professionals. Comprehensive coverage also contributes to labour mobility by ensuring workers of the minimum basic health care regardless of their province of residence. Finally, financing the provinces to provide a basic level of health-care services as a public service to its residents contributes to the equalization objective of assisting the provinces to provide comparable public services at comparable tax rates.

Universality — This requires that all of the insured persons in the province be entitled to the insured health services on uniform terms and conditions. This is perhaps less readily justified than some of the other conditions. The idea might be that health insurance represents a type of redistribution which is geared towards a different characteristic than income redistribution – i.e., health status. Full insurance of health status might be the ideal, which implies universality. There may, of course, be inefficiencies induced by full insurance in health as in many other items, for moral hazard and other reasons. The condition of universality puts full weight on equity relative to efficiency arguments. It also contributes to more uniform plans across the provinces, which contribute to labour mobility.

Portability — This criterion requires that waiting periods for eligibility cannot exceed three months for new residents, that residents travelling in other provinces be covered at health costs applicable in the latter (unless the two provinces have agreed on other sharing arrangements), that residents travelling abroad are insured at the rates of their home province, and that residents who move to another province be insured by their province of origin during a waiting period in the other province. Portability is obviously desired as a means of facilitating labour mobility. It is also a textbook case of a spillover benefit across the provinces since it illustrates circumstances in which the expenditure programs of one province have potential benefits to the residents of others.

Accessibility — To satisfy accessibility, a plan must not impede, by charges or other means, reasonable access to insured services by insured persons. In addition, it must provide reasonable compensation for the rendering of health services by medical practitioners or dentists, as well as providing payment to hospitals for their costs of insured health services. Accessibility guarantees that persons will not be precluded from health services because of limited means. This is compatible with viewing the provision of health services as partly serving an equity or redistributive objective or, equivalently, as being a public service. To make this and the previous criteria conditions for full receipt of the EPF grant recognizes that the health services being partly funded by federal money are contributing to goals of national importance.

Deductions for user charges and extra-billing — The Canada Health Act also provides that there shall be a deduction from the cash contribution to a province of an amount equal to that which has been charged through extra-billing by medical practitioners or dentists plus an amount equal to that which has been charged in respect of user charges for insured health services. The primary reason for wishing to provide an incentive for provinces not to engage in these practices is to avoid the accessibility of the plan from being eroded. As we have argued before, accessibility is an important ingredient in a health-care system which serves in part as a redistributive vehicle. There are, however, other reasons for penalizing these practices. Provinces might otherwise be tempted to use these sorts of measures to compete with other provinces both for doctors and for more productive members of the labour force (those which use the health-care system less). If all provinces engaged in such competition, it would be at least partly self-defeating in the end. Furthermore, the withholding of transfer funds against extra-billing and user charges might also be justified as incorporating some elements of need and cost differences into the transfer system. As mentioned earlier, the desire to assist the provinces in the ability to provide reasonably comparable public services at reasonably comparable tax rates requires that grants be based on differences in the need and cost of providing provincial public services, as well as on tax capacity differences. The ability of a province, say, to levy user charges will lessen its need for financing from the federal government. Indeed, it would be virtually impossible to incorporate need or cost into a grant formula without doing so by means of conditionality.

The Canada Assistance Plan

The Canada Assistance Plan (CAP) was introduced in 1966 to consolidate a number of welfare programs (such as welfare for the aged, the blind, the disabled, the unemployed, needy mothers, transients, and Indians) and to increase provincial discretion over expenditures according to provincial circumstances. Under the CAP, provinces are eligible for a 50-per-cent subsidy for expenditures made for welfare and assistance to the needy. The only condition is that of "need" of the recipient: the provinces must agree to adequately meet the basic requirements for food, shelter, clothing, fuel, utilities, household supplies, and personal requirements. The subsidies are open-ended, so the provinces are supposed to receive the transfers for all expenditures regardless of provincial population or the rates and categories of assistance that provinces decide upon. In recent years, most of the growth in the CAP grants has been due to growth in expenditures on related programs for the "have" provinces. This has pointed out a potential problem of the open-ended grants and has led to suggestions that the grants be based upon some form of per-capita system. Finally, as with most other federal transfer systems, the provinces have an opting-out option, wherein they can opt-out of the CAP system and receive compensatory payments. The only province to exercise this option has been Quebec. As compensation, the federal government abated five personal income tax points to the Quebec government.

Although the design of the current CAP system calls for unlimited grants to the provinces, the 1990 federal budget froze the rate of growth of CAP transfers for the first time to the "have" provinces of British Columbia, Alberta, and Ontario. This decision was unsuccessfully challenged by the "have" provinces in court, on the grounds that the federal government cannot unilaterally change the existing federal-provincial fiscal arrangements. The federal government's position is that these provinces are better able to finance their own programs. This argument could have implications for the whole issue of tax room between the federal and provincial levels of government.

The Tax Collection Agreements

The Tax Collection Agreements have remained virtually unchanged from a statutory point of view since their inception in 1962. However, they have been subject to a number of strains over the recent past and have undergone some potentially significant changes in the way they are administered. The commitment to use a common base and allocation formula, as well as rate structure, has continued intact and has even been respected by nonagreeing provinces. However, there have gradually crept in a number of practices which had the effect of fragmenting the tax base. There remain a number of concerns expressed by the provinces which could influence greatly the continuation of the current arrangements.

In the recent past, a number of innovations have been introduced into the Tax Collection Agreements which could be viewed as disharmonizing. Most of them have served to differentiate one province's tax structure from another's for provincial policy reasons. Presumably the reason they have been introduced is to reduce provincial dissatisfaction with the centralization of income tax policy. Originally, provinces agreed to the federal income base and rate structure and chose their own rate levels. The federal rate structure was accepted for both the personal and corporate tax structures, including those elements introduced as tax credits rather than deductions. As long as an effective equalization system was in place, the provinces could choose rates which were not too different from one another. However, while still respecting the common base, gradually the provinces were allowed to introduce provincial tax credits, provided they were not difficult to administer and provided they were "non-discriminatory."

The practice has grown considerably for both the corporate and the personal taxes. Provincial corporate tax credits of a variety of types now exist, most of them designed to encourage investment in particular sorts of activities. It would be difficult to maintain that they do not affect the efficiency of capital allocation within the federation and that they do not affect the complexity of the tax system. Similarly, at the personal level, most provinces have some special types of tax credit, some designed to be redistributive, some designed to assist with certain types of expenditures (e.g., housing), and some designed to encourage local saving. These measures influence the effective rate structure for the income tax, something that the Tax Collection Agreements were supposed to harmonize. In addition, they further fragment the national capital market by encouraging saving in local firms.

More recently, another significant departure has been allowed. Some western provinces have been allowed to implement a flat-rate tax, not on the basic federal tax, but separately on net income as defined by the federal income tax. This represents a significant departure from the principle of a common base and would thus appear to violate the principles of the Agreements. It is a reflection of the increasing desire of the provinces for power to influence their tax bases and the inability of the federal government to resist, given the growing importance of the provinces in the direct tax fields.

In addition to the base, the Agreements call for federal control over the rate structure (except as it can be affected by tax credits). This, too, is a matter of concern for the provinces, some of which would prefer to have some control over local redistributive policy. Their only recourse has been to make increasing use of tax credits.

The provinces also have some concern with purely administrative matters relating to tax collection. There has been some concern that ongoing installment payments of tax revenues to the provinces which are based on estimates of final assessments have been often too low, as reflected in final reconciliation payments. To the extent that this is true, the provinces effectively lose forgone interest on the moneys owing them. The provinces have also from time to time felt that federal auditing was not as careful as it might be on items involving provincial revenues alone (provincial tax credits and allocations across the provinces). This is a charge that has been levied by provinces, but is obviously difficult to substantiate. There are, of course, institutional means by which the federal government and the provinces can consult on concerns over the operation of the Agreements. Whether that can be extended to questions of policy, such as changes in the tax base, is a matter of judgment.

Whether the federal government can maintain its authority in the Tax Collection Agreements and in future tax harmonization schemes may depend to a considerable extent on whether it assumes a large enough share of the tax room. Given the relative size of provincial government spending, sufficient tax room for effective tax harmonization may require a continuing significant system of federal-provincial transfers to the provinces. From this point of view, reducing EPF transfers and ultimately rearranging the tax-room division may reduce the pressures for tax harmonization by reducing the federal government's ability to enforce them. In this same connection, it might be noted that changing the federal tax mix in favour of indirect taxes at the expense of direct taxes could further erode the federal government control over the income tax bases. This seems to be a likely outcome of the introduction of the GST.

At the moment, the system of tax harmonization does not go beyond the income taxes. There is some hope that the GST will be harmonized with the provincial retail sales taxes, and that is beginning to happen in some provinces (e.g., Quebec and Saskatchewan). Provincial resource taxes also remain highly differentiated, as well as inefficiently designed. The taxes themselves do not correspond with resource rents. For instance, in oil and gas, royalties are widely used, and they are equivalent to taxes on output or revenue with no deductions for costs. Mining tax schemes are often income-based, but they typically afford a set of write-offs which differ widely from economic costs. Furthermore, provinces sometimes use incentives delivered through the tax system to attract resource-related activities. Given the decentralization of resource taxes to the provinces, it is hard to overcome these inefficiencies. It is also difficult to address the interprovincial disparities in resource revenues which are the most important source of differences in tax capacity across the provinces. This makes the letter of Section 36(2) of the Constitution Act difficult to fulfill.

8 The Financial Consequences of Alternative Scenarios

Various observers have proposed a variety of alternative scenarios for the reallocation of economic powers. Most of them would involve considerable change in federal-provincial fiscal relations or relations among the federal government, Quebec, and the remaining provinces. We will be unable to do full justice to the various proposals. At best, we can offer a few observations about the consequences of the various scenarios for financial relations. Basically, there are three sorts of alternatives that we consider. The first is a decentralized federation in which significant powers are turned over from the federal government to the provinces. One version of this, though not the only possible one, is the Allaire Report adopted by the Liberal Party of Quebec. The second is a reallocation of responsibilities between the two levels of government with some going from the federal government to the provinces and some going in the other direction. The third is an asymmetric arrangement by which some responsibilities are decentralized to Quebec alone. Our interest is in the effect that these would have on the efficiency and equity of the common market.

It should be stressed at the outset that there is very little reliable empirical evidence on the costs and benefits associated with alternative divisions of powers. Given that the changes involve relatively major institutional rearrangements, it would be impossible to infer from any existing data what the consequences would be, either in the transition or in the longer term. Thus a great deal of judgment is necessarily involved.

A Decentralized Federation

Decentralization means different things to different persons, and different aspects of decentralization would have differing effects on the operation of the common market. It is useful to consider various elements separately using as a basis the broad categories of the public-sector budget.

Transfers to Individuals

Recall that two thirds of the program spending of the federal government is devoted to transfers of one sort or another. Thus, when we are talking about decentralizing on the expenditure side of the budget, significant amounts can come only from transfers. Transfers to individuals make up 50 per cent of the total. The major such transfers include unemployment insurance, public pensions, and family allowances. Conceivably, one could treat credits to individuals delivered through the tax system as transfers as well, including the low-income tax credit for the GST.

Each of these major transfers to individuals could readily be transferred to the provinces. Indeed, as we have already seen, unemployment insurance and pensions are at the federal level only as a result of constitutional amendment. Presumably, the argument for decentralizing such functions must be that they can be more efficiently delivered at the provincial level with more attention devoted to purely local considerations. Such a transfer would have a number of economic consequences which would have to be taken into consideration before the balance of benefits and costs is arrived at. One consequence is that the relative size of the federal and provincial governments would change. The federal government would have less need to occupy tax room presuming that the provinces finance the transfers from their own source revenues. Depending upon which type of tax room was turned over to the provinces, the implications will differ. If the transfer of tax room was in the direct tax field, the dominant federal position would be seriously eroded with the possible consequence that income tax harmonization would be jeopardized. On the other hand, if the transfer of tax room was of the indirect form, the adverse consequences for tax harmonization could be avoided. On the other hand, this latter would probably require that the federal government abandon its GST, something which they may not be prepared to do.

A second obvious consequence of decentralizing transfers to the provinces is that this would make it much more difficult for the federal government to achieve national equity objectives. The tax-transfer system is the main instrument of the federal government for that purpose. Abandoning the transfer side of the equation would make that more difficult. Similarly, if the transfer involved surrendering income tax room to the provinces, this would also hamper the redistributive efforts of the federal government. Whether this is a good thing or a bad thing depends upon one's view of equity as an objective and the role of the federal versus the provincial governments in achieving it.

A third consequence of decentralizing transfers to the provinces is that it contributes to the fiscal inequity of the federation. As mentioned earlier, transfers are equivalent to negative taxes, yet the Equalization system does not treat them as such. Different provinces will have different abilities to offer redistributive transfers with the consequence that fiscal equity will suffer. In principle, it would be possible for the Equalization system to take these into account; but that would involve redesigning the system.

Finally, there would be efficiency effects from decentralizing transfers. If different provinces offered different types of schemes, mobility of labour across provinces would be affected. There might also be some beggar-thy-neighbour competition in the provision of transfers to low-income persons across the provinces. At the same time, if all transfers were decentralized to a common level of government, there would be the possibility of rationalizing the system so as to avoid the conflicts between the schemes administered at the federal level and those administered by the provinces (e.g., unemployment insurance versus welfare). One way to avoid this problem for unemployment insurance is to transfer its delivery to the provinces, but use the federal spending power to induce minimum national standards and portability. This would seem to be a useful illustration of the advantages of decentralization combined with the use of the federal spending power to induce national objectives.

Transfers to Firms

Transfers to firms are a relatively smaller budgetary item. A substantial part comprises agricultural payments and regional development subsidies. As with transfers to individuals, considerable assistance to business is also achieved through the income tax system. Transfers to firms have a number of objectives. In the case of agriculture, much of it takes the form of public insurance to farmers faced with adverse demand or supply conditions. Other transfers have as an objective the development of low-income regions. Transfers might also be used as an industrial policy instrument targeted to particular industries such as those in high-technology areas.

Decentralizing transfers to firms to the provincial level might contribute to the purely efficiency-oriented goals of such transfers. However, there are a couple of disadvantages. For one, provincial transfers to firms are likely to distort capital markets causing a misallocation of resources across the economic union. They may also result in firms engaging in subsidy competition to attract businesses from other provinces, a practice which is at least partly self-defeating if all engage in it at the same time. Also, to the extent that the transfers are used for regional development purposes, they are yet another instrument in the arsenal of the federal government for pursuing national equity. Removing this instrument reduces the ability of the federal government to achieve equity objectives. Of course, there are those who would argue that industrial subsidies are an inefficient instrument for this purpose and who see decentralizing them as a way to reduce their use. One might have sympathy for that on economic policy grounds. However, whether economic policy objectives should be used as a basis for deciding the division of powers is a matter of judgment. Finally, related to the equity objective is the use of subsidies to firms as forms of social insurance. It can be argued that social insurance can be more effectively implemented at the federal level than at the provincial level.

Expenditures on Goods and Services

As the evidence presented earlier shows, expenditures on goods and services are already quite decentralized in the Canadian federation. Most major services of a purely local or quasi-private nature are already provided by the provinces. These include such things as education, health, welfare, and transportation, as well as all local government services. It is not clear that there is much scope for decentralizing federal expenditures on goods and services, at least in terms of magnitudes of expenditures. A significant proportion of federal expenditures on goods and services is for defence, and few would argue for decentralizing those in a federation. Presumably if some regulatory functions, such as environmental, agricultural, or communications were to be decentralized, as discussed later, there would be some saving on the costs of operating those services at the federal level. However, the amount of money involved would be relatively small. This being the case, the purely financial consequences of the decentralization of goods and services are likely to be relatively small.

Of course, some would argue that despite the apparent decentralization of expenditure responsibilities to the provinces, the federal government nonetheless exercises some control via the use of the spending power. Reducing the use of the spending power, say, by requiring provincial agreement, would make the federal government less intrusive here.

Transfers to Governments

Transfers to governments currently stand at 22 per cent of program expenditures of the federal government. As already stressed, they simply reflect the fact that the federal government is raising more revenue than is necessary for its own expenditures (including debt service) and transferring the proceeds to the provinces. Decentralizing these expenditures simply means requiring the provinces to occupy more tax room. The provinces would be required to finance a higher proportion of their expenditures from their own source revenues. The advantage of this is seen by some to require provincial governments to be more accountable for their expenditures.

As with the decentralization of transfers to individuals, there are some disadvantages to doing this. The passing on of tax liabilities to the provinces reduces the share of tax room occupied by the federal government relative to the provinces. As mentioned, to the extent that this occurs in the direct tax system, it reduces the ability of the federal government to encourage harmonization with provincial income tax systems, and it reduces the ability of the federal government to achieve national equity objectives. Also, to the extent that the transfers are used to fulfill the sorts of roles mentioned earlier, these would be compromised to the extent that transfers were eliminated.

It could be the case that some, but not all, transfers are abolished. For example, transfers involving the spending power might be eliminated (primarily EPF and CAP), while Equalization is retained. The form of the equalization would then have to be determined. If the existing formula were retained, the elimination of EPF and CAP would itself cause a sizable change in the amounts owing under Equalization since the increase in provincial tax room would automatically be equalized. Even so, the effectiveness of equalization in the broader sense would be diminished. As discussed earlier, EPF and CAP both complement Equalization. The EPF system implicitly equalizes the have provinces down as well as the have-not provinces up – i.e., unlike the Equalization system, it is a gross system. The CAP program can be viewed as equalizing for negative tax liabilities (welfare payments) as well as for need and cost to the provinces. Eliminating these programs will therefore reduce the effectiveness of equalization as a way of enabling provinces to provide comparable levels of public service at comparable tax rates.

To the extent that the CAP is justified on general equalization grounds, it could be converted to an explicit equalization-type scheme whereby transfers to each province are based on a national average set of welfare costs. The grants could be block-type in form so as to reduce the incentive for provinces to exploit the incentive implicit in the matching rate.

Tax Assignment

Much of the discussion of decentralization concentrates on the expenditure side rather than the tax side. However, there are real issues as to which taxes to decentralize to finance the increased expenditure responsibilities. We have already mentioned what is at stake here so we can be rather brief. Ultimately, the issue is whether to decentralize indirect or direct taxes. From a purely economic perspective, there are good reasons to decentralize indirect rather than direct taxes. That would be in accordance with the accepted theory of tax assignment in a federal system. Maintaining as large as possible federal presence in the direct tax fields is important for reasons which we have repeatedly stressed. First, it is more important to have a harmonized direct tax system than an indirect tax system, and that is more likely to be achieved the more important is the federal government in the direct tax fields. Second, in an economy in which expenditures on such things as health, education, and welfare are decentralized to the provinces and in which many transfers may be as well, the direct tax system becomes the main instrument for pursuing equity at the federal level. Thus it is better for the federal government to retain income tax room than indirect tax room. Finally, that part of the income tax system which applies specifically to business income (both corporate and unincorporated) is more efficiently administered at the federal level. Provincial taxes on business income can give rise to capital market distortions within the federation given the degree of mobility of capital. The primary taxation of resources seems to be settled at the provincial level of government as a consequence of the historically given assignment of property rights to resources with the provinces.

While the above reassignment of taxes might be in accord with economic principles, it may well not be the most likely outcome, given recent events. Given that the GST is now in place, it may be tempting to decentralize income tax responsibilities to the provinces and strengthen the indirect tax at the central level. The latter holds out the prospect of a harmonized indirect tax system, at least in the short run. However, given the complexities of operating a value-added tax in a multijurisdictional economy, this really requires virtually complete federal dominance in the field. Even allowing the provinces to maintain separate rates would complicate the system, at least if the provincial parts were to be based on a multistage tax. The crediting system becomes very complicated when different provinces have different tax rates. A much more practical approach would be for the federal government to take over the field completely. The gain would be a harmonized indirect tax; the loss would be federal influence over equity in the tax system, given that the federal government would inevitably lose direct tax room.

Under such a reassignment, the direct tax room would be much more heavily in favour of the provinces. Apart from the sacrifice in federal control over equity, there is a real question as to whether income tax harmonization itself could be maintained. To do so would presumably require at the least a considerably relaxed type of tax-collection agreement. At the most, the provinces would agree to a common base, but have their own rate structures. Thus the provinces could apply their own equity standards internally, which might be viewed as a benefit. Whether or not there would be a single tax-collecting authority is an open question. Depending upon what happens to the magnitude of federal-provincial transfers, such a system may or may not provide lasting harmonization.

In any case, it is not clear that any constitutional measures are involved here. The existing system of tax assignment and harmonization has evolved in a constitutional setting which is very permissive about what various governments can do. On the other hand, if a constitution stipulated certain principles of maintaining the economic union as some have suggested, and as we discuss later, that would presumably have some effect on the sorts of discriminatory tax policies that provinces could undertake.

Regulatory Functions

Many of the economic functions that it is proposed to decentralize to the provinces are, in fact, regulatory functions. These do not have significant effects on financial relations between levels of government, but do affect the operation of the federal economy itself. They do so to the extent that they impinge upon the free flow of goods, services, and factors of production across provincial boundaries. A detailed treatment of this would take us rather far afield. However, a few remarks are in order.

In the case of markets for goods and services, provincial regulation could restrict interprovincial trade. The regulation of agriculture is a prime example. Much of the trade in agricultural goods now takes place across provincial borders given the restrictions that exist internationally. Federal regulation at least enables there to be some semblance of rationalization within the federation. If the provinces regulated agriculture, the opportunity would exist for considerable balkanization within the provinces. Thus it is unclear that the large quota which Quebec dairy producers enjoy and which enables them to export to the rest of Canada would survive the decentralization of agricultural regulation. The same might apply for other resources such as fish and nonrenewable resources (oil and gas). Regulation of traded services such as financial intermediation, communications, and transport could also fragment the customs union in goods and services. An example of the problems that can arise is found in the decentralized regulation of financial intermediation that exists in the United States. To a great extent, decentralization of regulatory functions applying to goods and services are fundamentally incompatible with the maintenance of an economic union.

Similar statements might apply to regulation of factor markets. The regulation of labour markets and immigration could both affect the free flow of labour across the provinces. Similarly, capital market regulation at the provincial level would cause distortions in the allocation of capital within the federation. As with the markets for goods and services, regulation of factor markets at the provincial level would almost inevitably interfere with the efficient functioning of the common market.

A key issue regarding regulatory functions is the extent to which they apply to transactions with the rest of the world. In any common market or customs union, if the policies of the individual jurisdictions vis-à-vis the rest of the world differ, opportunities for arbitrage arise. In the Canadian context, this is presumably most important with respect to factor markets. In the case of goods markets, it seems to be accepted by most observers that a common tariff policy would apply and would be the responsibility of the federal government. It is true that individual provinces implementing different sales taxes might make it preferable for importers to bring goods in through low-tax provinces and eventually ship them to other provinces. However, provincial sales-tax liability rests legally with the eventual sale of the product to domestic residents. Any incentive to avoid the law already exists in the present system.

In the case of factor markets, the incentives can be much more important. Consider labour. If the responsibility for immigration were decentralized to the provinces and if free mobility were maintained for labour within the federation, as it should, different immigration policies by different provinces could be seriously compromised. To be specific, Quebec has as an objective the attraction of immigrants who can increase the size of the French-speaking community. Data even now apparently show that a high proportion of immigrants coming into Quebec resettle in another province after a period of residency in Quebec.[1] If immigration policy were completely decentralized, it is not hard to imagine a very liberal immigration policy in Quebec accompanied by a large migration from Quebec to the rest of Canada being incompatible with the immigration objectives of the rest of Canada. This is potentially a very serious drawback to full decentralization; the decentralization of powers over immigration might be effectively incompatible with the maintenance of a true common market in labour. It is unlikely that similar problems would arise in the case of capital markets since there is no analogy of border controls.

A Reallocation of Responsibilities

There are various ways in which responsibilities could be reallocated between the federal and provincial governments which would not represent a unilateral decentralization of powers. In other words, some functions would be centralized and while decentralized resulting in what some have referred to as "renewed" federalism. Obviously, the alternatives are endless and we cannot hope to present and evaluate them. What we can do is to propose a list of functions which, according to our previous analysis, might fruitfully be reallocated. As always, evaluation of the various alternatives depends upon one's views about equity as an objective of government policy, both federal and provincial.

Reassigning Tax Responsibilities

In some sense, the reassignment of tax responsibilities is the simplest to deal with from an economics point of view. There are two aspects to the assignment problem. One is how to allocate the mix of taxes between the levels of government, and the other is the relative size of total tax collections by the federal government and the provinces. In some sense, these are separable issues. Furthermore, it is not obvious that they are issues that should, or could, be written into the constitution.

Based on our previous discussion, one attractive reassignment of taxes would be for the federal government to vacate the indirect tax field and allow the provinces to be the sole occupant. The advantage of this comes more from strengthening the federal government's presence in the income tax field than from any advantage the provinces have in the indirect tax fields. The point is simply that the federal government can, at most, be dominant in one of the two fields, and it is more attractive for that to be the income tax field. The benefits of harmonization and ability to achieve equity standards are important factors in this view. This does not mean that the provinces cannot co-occupy the income tax fields. However, the chances that they will do so in a harmonized system are better if the federal government retains a dominant position.

Furthermore, it is not necessary that the harmonization involve both the base and rate structures. One could follow the advice of the Ontario Economic Council [1983] and allow the provinces to apply their own rate structures and a commonly agreed base. As long as the federal government maintained dominance in the income tax field, national redistributive objectives could be addressed.

A more serious matter concerns the allocation of corporation taxation. From a purely economic perspective, there are significant efficiency advantages from assigning this tax to the federal level. Corporate income represents a relatively highly mobile factor of production, and decentralizing the taxation of it invites a misallocation of capital across jurisdictions as well as wasteful tax competition. At the same time, it might be administratively difficult to have the corporate tax solely at the federal level, while the personal income tax is shared. As is well known from tax theory, there is a fundamental interdependence between the two taxes.[3] One might like to integrate the two taxes to avoid double taxation and to eliminate any disadvantages to firms from incorporating.

Given the above structure of taxes, a wide variety of allocations of total tax revenues between the federal and provincial levels of government would be possible. The precise allocation would depend jointly upon the expenditure responsibilities at the two levels as well as the desired amount of federal-provincial transfers for equalization and other purposes.

Transfers to Governments

Some revision of the system of transfers to provinces might be possible, though the desired extent would depend upon the degree of equalization that one wanted to have prevail. A couple of things suggest themselves here. In a sense, there are three main reasons for federal-provincial transfers. One is the equalization objective to which, as we have stressed, all major transfers contribute. The second is the spending power reason which seems to be largely motivated by national equity objectives and, to a lesser extent, by the efficiency advantages of harmonizing public services to individuals. The third is the tax-harmonization argument which suggests that in a federation with decentralized expenditures, tax collections should be more centralized. One change which would contribute to the third without detracting from the other two would be to replace the tax-transfer component of the EPF system with per-capita cash grants. This would enhance the federal presence in the direct tax fields without changing at all the amount effectively transferred to the provinces.

If one puts less stress on national equity issues, one could abandon large shared-cost programs like the CAP and turn their responsibilities over to the provinces completely. This would weaken the contribution of such programs to the equalization objective, though presumably the latter could be addressed directly by reforming the Equalization scheme. Alternatively, the CAP could be recognized as a way of equalizing differences in the demands transfer payments put on different provinces. It currently does so in a way which gives strong incentives to the provinces to increase welfare spending through "50-cent dollars." As mentioned, the latter could be avoided and the equalizing feature retained if transfers in the form of welfare payments were treated as negative taxes for the purposes of calculating equalization.

Finally, if one viewed the EPF scheme largely as a component of equalization (which it is except for the conditions imposed on health care), the same effectiveness of equalization could be achieved with less transfer of funds by targeting the funds to the provinces most in need rather than by equal per-capita transfers to all provinces. This would reduce the size of the transfers and thus the size of the federal budget, though at the same time reducing the importance of the federal government on the revenue side. We have argued already that there are certain advantages to a large federal presence in the income tax fields to begin with.

Transfers to Persons and Firms

A substantial proportion of transfers to individuals and firms are already delivered through the federal government, and we have already discussed the consequences of transferring them to the provinces. The other alternative is to centralize some of the transfers delivered at the provincial level to the federal government. The main example of this would be the provincial welfare payments systems, as opposed to welfare services provided by the provinces. In a sense, one could argue that it is consistent to have these transfers at the same level of government as other transfers such as unemployment insurance. Both are aimed at low-income persons and there is an advantage from coordinating their provision. As well, since transfers are like negative taxes, they should be controlled at the same level as the income tax structure. Furthermore, these transfers are an important component of the equity instruments of the government. At the same time, welfare payments are not administered like a tax. They are provided on a more discretionary basis using criteria such as need. There may be some administrative advantage from decentralizing their provision. If so, perhaps unemployment insurance should be decentralized to be at the same level.

A stronger case might be made that transfers to firms should be at the central level. Since firms are mobile in their location, such transfers when used at the provincial level can give rise to interprovincial competition and inefficiencies in the allocation of capital, much like provincial corporate tax policies. Again, it is not clear how such an assignment can be written into the constitution. Perhaps the best that can be done is to write into the latter the maintenance of the unimpeded flow of goods, services, and factors as a principle binding all governments.

Regulatory Policies

There is little to add to the few comments made above concerning regulatory policies. By their very nature, such policies often tend to interfere with the efficiency of the internal common market. The costs are less, the less mobile interprovincially are the objects of the regulation. Presumably, the most costly are those applying on capital and traded goods and services. Some regulatory matters necessarily concern matters which transcend borders. Examples include environmental regulation, coastal fisheries, and immigration policies.

Asymmetric Federalism

The argument for asymmetric federalism is based partly on the notion that the distinctiveness of language and culture in Quebec can only be protected and fostered by the retention of certain economic responsibilities at the provincial level, and this is a problem unique to Quebec. Vaillancourt [1991] has argued that language in the workplace is an important aspect of human capital, and that its value can best be protected by decentralizing economic responsibilities, especially those for labour market issues, but also for capital markets. In principle, there is no *economic* reason why some functions cannot be decentralized selectively to one province (i.e., Quebec) and not to others. However, many of the issues raised earlier about the implications for the economic union will apply. As well, there will be some special problems of coordination and equity among residents of various provinces that will exist. Indeed, one of the key issues in such an asymmetric arrangement concerns the extent to which one province could, or should, opt out of national redistributive programs. Let us consider economic union aspects and redistributive aspects in turn.

Implications for the Economic Union

The effects of the decentralization of various powers selectively to a single province are similar to the more general effects of decentralization mentioned before. Decentralization can involve expenditure responsibilities, tax responsibilities, and regulatory functions. As discussed above, expenditures are already quite decentralized in Canada, and most proposals would retain that amount of decentralization. Local control of such things as health, education, and welfare can affect the operation of the common market in a couple of ways. For one, different mixes and structures of such programs can effect the allocation of factors of production across jurisdictions (especially labour and investment). Different *levels* of service provision can also have such effects. Finally, the very fact of mobility of factors of production can induce jurisdictions to engage in competitive service provision which can be disadvantageous to all in the long run. Of course, one of the characterizing features of the Canadian federation which supports the argument for asymmetry is that labour mobility between Quebec and the rest of Canada is less than among the other provinces. An important exception to this is the apparently low rate of retention of immigrants in Quebec. This is of considerable relevance for the possible decentralization of the responsibility for immigration policy.

In a federation, the inefficiencies resulting from decentralized expenditure responsibilities can be at least partially offset by a system of redistributive grants among provinces, and by the use of the spending power to induce common standards of provision. One of the advantages of such an arrangement is that the benefits of decentralization in terms of the efficiency of service delivery can be made compatible with the broader efficiency (and equity) objectives of the federation. In an asymmetric federation, the outcome depends very much upon the extent to which the central government can engage in such offsetting measures.

The ability of the federal government to compensate for inefficiencies (and inequities) induced by provincial behaviour depends jointly upon the ability of the federal government to make redistributive grants to the provinces and the ability to use the spending power. These, in turn, are contingent on the federal government continuing to occupy a larger part of the tax room than their own expenditure responsibilities would require. If the asymmetric arrangement called for a selective decentralization of tax responsibilities as well, the ability of the federal government to offset provincially induced inefficiencies and inequities would be correspondingly reduced for part of the federation. The result would be threefold.

First, decentralizing both expenditure and tax responsibilities selectively to Quebec but not to the rest of the country would result in an asymmetric incentive for Quebec to engage in beggar-thy-neighbour policies relative to the rest of the provinces. Given the inability of the other provinces fully to respond, the result might be an outcome in which Quebec is able to attract selective factors to their province and others are not able to "retaliate." In a sense, such a possibility now exists to some extent already in the federation. For example, provinces can leave the Tax Collection Agreements and set up their own discriminatory systems. Presumably, in an asymmetric federation, such possibilities would be more open to Quebec than to the other members.

Second, horizontal inequity would exist between Quebec on the one hand and the rest of the provinces on the other. We return to that below.

Third, decentralizing taxes to Quebec but not to other provinces would ultimately lead to pressures for Quebec to have its own distinctive income tax systems with little harmonization with the rest of the provinces. To some extent that exists now, since Quebec is not a participant in the Tax Collection Agreements. The consequences of the reduction in pressure for tax harmonization would be a further segmentation of capital and labour markets between Quebec and the rest of Canada, a one-sided incentive for Quebec to engage in beggar-thy-neighbour tax policies vis-à-vis the remaining provinces, and a loss of nationwide equity.

Asymmetric decentralization of regulatory functions could lead to similar efficiency problems. As mentioned earlier, the decentralization of virtually any regulatory role over markets for goods and services, labour, and capital is bound to give rise to compromises in the economic union. However, the unilateral decentralization to Quebec also provides a possible one-sided opportunity for that province to engage in beggar-thy-neighbour policies designed to attract activity and rents from the other provinces. There are also some particular issues that are of particular concern in this regard. These include environmental policies, agricultural policies, and communications.

One possible response by the federal government to the use of regulatory and other policies for beggar-thy-neighbour policies by Quebec would be to respond in kind – i.e., the federal government might become the agent for the rest of Canada to engage in tax, expenditure and regulatory competition with Quebec. Indeed, in some circumstances, this may be the natural outcome. Obviously, this could fragment the common market seriously.

Finally, to repeat a point that was raised earlier, perhaps the greatest pressure will come on labour markets. Decentralization of the regulation of language and cultural policies, which seems a likely outcome in any case, is likely to reduce the two-way mobility of labour between Quebec and the rest of Canada. This seems already to have happened. More important pressures are likely to come from the decentralization of immigration policies. Given the apparently low degree of retention of immigrants in Quebec, decentralizing immigration will immensely increase the incentive to open the immigration doors into Quebec. In the presence of labour mobility within the federation, this will basically frustrate any immigration policy undertaken in the rest of Canada. This could well ultimately force the institution of real barriers to mobility between the two parts of the country.

Implications for National Equity

The asymmetric decentralization of powers to Quebec will also have implications for the degree of equity achieved within the federation. There are a number of aspects to this, both horizontal and vertical, and the extent of inequity depends upon precisely which powers are decentralized to the provinces. Horizontal inequity will result to the extent that equalization is reduced in effectiveness. This includes equalization as currently achieved by the Equalization program as well as equalization implicit in the EPF and CAP programs. The presumption is that, at most, an asymmetric federation will retain Equalization, but not the other major transfers. Depending upon how the Equalization system itself responds to decentralized tax powers, horizontal inequity could be reduced.

Equity goals across the federation will also be compromised since the federal government will not have the full range of instruments for ensuring equity across all parts of the federation. The decentralization of direct taxes to Quebec will mean that the federal government can no longer control redistributive policies within Quebec. The elimination of the federal spending power removes another instrument the federal government has for achieving national equity within the federation. At best, this will simply mean that there will be different standards of vertical equity across the two parts of the federation. At worst, the decentralization of redistributive policies will induce pressures for tax and expenditure competition which might work to the disadvantage of the worst-off persons in the economy.

Recall that the argument for applying national equity standards rested on the notion that otherwise equal persons should be treated in a similar way no matter where they reside. This seems to us to be in a sense a defining characteristic of citizenship. It does, however, require that there be a minimum willingness to share among Canadians regardless of residence. It may well be that Quebecers no longer wish to participate in equity nationwide to that extent. If so, an asymmetric federation may be the only way to preserve the other benefits of federalism.

Thus, on balance, asymmetric federalism will reduce the efficiency of the economic union, perhaps induce beggar-thy-neighbour policies between Quebec and the rest of the country, impose serious pressures on labour migration because of the decentralization of immigration, and compromise equity within the federation. It is natural to wonder whether the legitimate cultural and language objectives can be achieved without the concomitant decentralization of purely economic functions.

Notes

CHAPTER 2

1 Buchanan has written widely on these issues. The basic methodology may be found in Buchanan and Tullock [1962]. A general review of the literature is in Inman [1987].

2 In a very famous study, Mirrlees [1971] computed the structure of the ideal redistributive income tax under a set of reasonable assumptions about taxpayer behaviour. He found, much to his surprise, that the "optimal income tax" structure did not differ much from a flat rate with a fixed-exemption level. This work has spawned an enormous literature, none of which has cast doubt on the qualitative results of Mirrlees.

CHAPTER 3

1 The details of the unemployment insurance reference may be found in Hogg [1985].

2 See Hogg [1985], from which many of the following arguments are drawn.

3 This argument has been developed in more detail in Boadway [1986].

4 A complete discussion of the various points of view on the spending power provision of the Meech Lake Accord may be found in Swinton and Rogerson [1988].

5 A more detailed discussion of the consequences for federal-provincial fiscal relations of the recent budgetary measures may be found in Boadway [1989 and 1990].

6 These arguments are summarized in McLure [1983].

7 The Canadian Medical Association apparently feels the same. The court action that they had initiated to challenge the constitutionality of the Canada Health Act was dropped.

8 CAP transfers to the three have provinces were also unilaterally restricted to increases of 5 per cent, a move which was upheld by the Supreme Court of Canada.

9 This is discussed fully in Boadway, Bruce, and Mintz [1987]. There is a sizable literature on the issue of why creditor nations offer tax credits since it apparently involves a pure loss of revenue to them. The issue is yet to be resolved.

CHAPTER 4

1 This seems to be true of many of the arguments presented to the Bélanger-Campeau Commission, such as Courchene [1991]; Migué [1991]; and the Québec Chambre de Commerce [1991]. It is also true of the Allaire Report [1991].

2 This is discussed in detail in Harris and Purvis [1991].

3 These are discussed fully in Boadway and Flatters [1982]; and Boadway and Wildasin [1984].

4 It was discovered by Buchanan and Goetz [1972], and analysed more formally by Flatters et al. [1974].

5 This phenomenon was originally discovered by Buchanan [1950]. The above example is discussed in further detail in Boadway and Flatters [1982].

6 This is also true of municipal governments. We restrict our attention here to the provincial level since the constitutional responsibilities of municipalities vis-à-vis the provinces are not at stake.

7 In Canada, provincial sales and excise taxes are almost always levied on a residence basis. One reason for this is that taxes on a residence basis may be deemed not to be taxes on interprovincial transactions and, therefore, do not violate constitutional restrictions on provincial taxes. The exception is in the resource-tax area where provinces levy royalties and now can levy any type of tax they wish.

8 For some reason, cross-international-border shopping escapes provincial sales taxation altogether. In principle, these taxes could be collected at borders along with federal taxes.

9 The term quasi-private is conventionally used to describe goods and services provided through the public sector, but not following market principles. It is often assumed that they are offered either on the basis of household characteristic (e.g., health) or on a more or less equal per-capita basis (e.g., education).

CHAPTER 5

1 This is demonstrated in Stiglitz [1987].

2 This is demonstrated in Sadka [1976].

3 In the seminal study, Mirrlees [1971] found the optimal income tax to be not too different from a flat-rate tax – i.e., one with a given exemption level and a constant marginal tax rate. A general survey of the results of this literature may be found in Tuomala [1990].

4 Although the principle of horizontal equity is typically an honoured one in the tax policy literature, there are a variety of circumstances in which it should be violated by an optimal redistributive tax in theory. For example, if persons have different tastes or face different prices, horizontal equity may be violated because the equity-efficiency trade-offs will differ for persons at the same utility level. The principle of horizontal equity is discussed further in Atkinson and Stiglitz [1980].

Chapter 6

1 This section draws on and extends the ideas introduced in Boadway [1991].

2 This view is summarized in the submission of Migué [1991] to the Bélanger-Campeau Commission.

3 A recent example of this is Breton [1990].

4 This perspective has been rigorously presented in Inman [1987]. It might also be found in the classic by Buchanan and Tullock [1962].

5 A good recent technical survey may be found in Blackburn and Christensen [1989].

6 A discussion of the contractarian principle may be found in Gordon [1976]. The methodology is often associated with Rawls [1971], though it was prominent in the economics literature through the work of Harsanyi [1955]. In fact, the same procedure was used by Buchanan and Tullock [1962] to explain the redistributive role of government.

7 See, for example, Brennan and Buchanan [1980]. This book stresses both the purely efficiency role of government and its potential for malevolent behaviour. As stated before, I find this to be an unduly restrictive view of government.

8 Summary statements may be found in Oates [1972]; and Boadway and Wildasin [1984].

9 This is discussed fully in Boadway and Flatters [1982]; and Economic Council of Canada [1982].

10 This argument is developed more fully in Boadway [1989]; and Boadway and Bruce [1991].

11 See McLure [1983] for a complete discussion of this.

12 It might be argued that, as with regulatory functions, tax harmonization can be brought about by methods other than direct federal control. Examples might include the agreement to a "Code of Conduct" on taxes or a consultative mechanism whereby the federal government and the provinces coordinate and agree on tax structures.

13 This argument is discussed more fully in Boadway [1990]. There it is argued that from a federal-provincial fiscal relations point of view, the federal Goods and Services Tax and the reduction in transfers to the provinces will have adverse effects.

Chapter 7

1 Note that provincial personal income taxes are calculated by applying provincial rates to the basic federal income tax. Accordingly, personal tax points are expressed as a percentage of the latter. On the other hand, provincial corporate taxes are calculated based on taxable income, and so are corporate tax points.

2 This point is developed in Boadway and Flatters [1982]; and Economic Council of Canada [1982].

3 In this latter case, transfers are said to be made according to the "principle of derivation." See Breton and Scott [1978].

4 A full catalogue of such grants may be found in the document published periodically by the federal government entitled, *A Descriptive Inventory of Federal-Provincial Programs and Activities*.

5 This is often referred to as "beggar-thy-neighbour" policies. A thorough discussion of the effects of interprovincial competition and distortions may be found in Trebilcock et al. [1983].

6 Some possible empirical indicators are discussed in Economic Council of Canada [1982].

7 The idea of using federal-provincial transfers for this purpose has been around a long time in Canada; see Graham [1964]. It could be argued that the idea goes back to the Rowell-Sirois Commission [1940].

8 These arguments were made by Arrow [1963].

Chapter 8

1 See the discussion in Brenner [1991]. Of course, it is always possible that decentralized immigration policies would increase the retention rate as well as the number of immigrants admitted, resulting in an uncertain effect on the rest of Canada.

2 For a detailed discussion of this, see Boadway, Bruce, and Mintz [1987].

References

Allaire Report [1991]. *A Québec Free to Choose.* Report of the Constitutional Committee of the Quebec Liberal Party, January.

Arrow, K. J. [1951]. *Social Choice and Individual Values.* New Haven: Yale University Press.

______ [1963]. "Uncertainty and the welfare economics of medical care." *American Economic Review* 53:942-73.

Atkinson, A. B., and J. E. Stiglitz [1980]. *Lectures on Public Economics.* New York: McGraw-Hill.

Besley, T., and S. Coate [1991]. "Public provision of private goods and the redistribution of income." *American Economic Review*, forthcoming.

Blackburn, K., and M. Christensen [1989]. "Monetary policy and policy credibility." *Journal of Economic Literature* 27:1-45.

Blackorby, C., and D. Donaldson [1988]. "Cash versus kind, self selection and efficient transfers." *American Economic Review* 8:691-700.

______ [1989]. "The case against the use of the sum of compensating variations in cost-benefit analysis." *Canadian Journal of Economics* 23:471-94.

Blomqvist, A., and H. Horn [1984]. "Public health insurance and optimal income taxation." *Journal of Public Economics* 24: 353-72.

Boadway, R. W. [1986]. "The economics of the system of federal-provincial fiscal arrangements." Report prepared as Expert Testimony for Winterhaven Stables Ltd. versus The Attorney General of Canada, November.

______ [1989]. "Federal-provincial fiscal relations in the wake of deficit reduction." In *Canada: The State of the Federation 1989*, eds. Ronald L. Watts and Douglas M. Brown. Kingston, Ont.: Institute of Intergovernmental Relations, pp. 107-35.

______ [1990]. "The budget and the evolution of federal-provincial fiscal relations." In *Policy Forum on the February 1990 Federal Budget*, ed. M.F.J. Prachowny. Kingston, Ont.: John Deutsch Institute for the Study of Economic Policy, pp. 1-11.

______ [1991]. "Constitutional design in a federation: an economist's perspective." In *Options for a New Canada*, eds. R. L. Watts and D. M. Brown. Toronto: University of Toronto Press, pp. 237-57.

Boadway, R. W., and N. Bruce [1984]. *Welfare Economics.* Oxford: Basil Blackwell.

______ [1991]. "Pressures for harmonization of income taxation between Canada and the United States." In *Canada-U.S. Tax Harmonization*, eds. J. Shoven and J. Whalley. Cambridge: National Bureau of Economic Research, forthcoming.

Boadway, R. W., N. Bruce, and J. M. Mintz [1987]. *Taxes on Capital Income in Canada.* Toronto: Canadian Tax Foundation.

Boadway, R. W., I. Cromb, and H. Kitchen [1989]. "The Ontario corporate tax and the Tax Collection Agreements." Paper submitted to the Ministry of Treasury and Economics, Government of Ontario, Toronto.

Boadway, R. W., and F. R. Flatters [1982]. *Equalization in a Federal State: An Economic Analysis.* Ottawa: Supply and Services Canada.

Boadway, R. W., and M. Marchand [1990]. "The use of public expenditures for distributive purposes." Queen's University Discussion Paper no. 796, Kingston, Ont.

Boadway, R. W., M. Marchand, and P. Pestieau [1991]. "Optimal linear income taxation in models with occupational choice." *Journal of Public Economics*, forthcoming.

Boadway, R. W., and D. E. Wildasin [1984]. *Public Sector Economics*, 2nd ed., Boston: Little, Brown & Co.

______ [1990]. "Optimal tax-subsidy policies for industrial adjustment to uncertain shocks." Oxford Economic Papers, no. 42, pp. 105-34.

Brennan G., and J. M. Buchanan [1980]. *The Power to Tax: Analytical Foundations of a Fiscal Constitution.* New York: Cambridge University Press.

Brenner, R. [1991]. "Canadian choices." In *Economic Dimensions of Constitutional Change*, eds. R. W. Boadway, T. J. Courchene, and D. D. Purvis. Kingston, Ont.: John Deutsch Institute for the Study of Economic Policy, forthcoming.

Breton, A. [1965]. "A theory of government grants." *Canadian Journal of Economics and Political Science* 31:175-87.

______ [1990]. "Centralization, decentralization and intergovernmental competition," 1989 Kenneth R. MacGregor Lecturer, Institute of Intergovernmental Relations, Queen's University, Kingston, Ont.

Breton, A., and A. Scott [1978]. *The Economic Constitution of Federal States*. Toronto: University of Toronto Press.

Buchanan, J. M. [1950]. "Federalism and fiscal equity." *American Economic Review* 40:583-99.

Buchanan, J. M., and C. Goetz [1972]. "Efficiency limits of fiscal mobility: an assessment of the Tiebout model." *Journal of Political Economy* 1:25-43.

Buchanan, J. M., and G. Tullock [1962]. *The Calculus of Consent*. Ann Arbour: University of Michigan Press.

Clarkson Gordon [1988]. *The Feasibility of a Self-Administered Income Tax System for British Columbia*, mimeo.

Courchene, T. [1991]. "A community of Canadas." Paper submitted to the Quebec parliamentary commission on the political and constitutional future of Quebec (The Bélanger-Campeau Commission), Quebec.

Diamond, P. A. [1981]. "Mobility costs, frictional unemployment, and efficiency," *Journal of Political Economy* 89:798-812.

Economic Council of Canada [1982]. *Financing Confederation*. Ottawa: Supply and Services Canada.

Flatters, F. R., et al. [1974]. "Public goods, efficiency and regional fiscal equalization." *Journal of Political Economy* 3:99-112.

Gordon, H. S. [1976]. "The new contractarians." *Journal of Political Economy* 84:573-91.

Gordon, R. H., and H. R. Varian [1988]. "Intergenerational risk sharing." *Journal of Public Economics* 37:185-202.

Gotlieb, A. [1991]. "The changing structure of the world community." In *Economic Dimensions of Constitutional Change*, eds. R. W. Boadway, T. J. Courchene, and D. D. Purvis. Kingston, Ont.: John Deutsch Institute for the Study of Economic Policy, forthcoming.

Graham, J. [1964]. *Intergovernmental Fiscal Relationships*. Toronto: Canadian Tax Foundation.

Guesnerie, R., and K. Roberts [1984]. "Effective policy tools and quantity controls." *Econometrica* 52:59-86.

______ [1987]. "Minimum wage legislation as a second best policy." *European Economic Review* 31:490-98.

Harris, R. G., and D. D. Purvis [1991]. "Some economic aspects of political restructuring." In *Economic Dimensions of Constitutional Change*, eds. R. W. Boadway, T. J. Courchene, and D. D. Purvis. Kingston, Ont.: John Deutsch Institute for the Study of Economic Policy, forthcoming.

Harsanyi, J. C. [1955]. "Cardinal welfare, individualistic ethics and interpersonal welfare comparisons." *Journal of Political Economy* 63:309-21.

Hogg, P. [1985]. *Constitutional Law of Canada*, 2nd ed. Toronto: Carswell.

Inman, R. [1987]. "Markets, governments, and the new political economy." In *Handbook of Public Economics*, eds. A. Auerbach and M. Feldstein. New York: North-Holland, vol. 2, pp. 647-769.

Johnson, A. [1985]. "Federal-provincial fiscal relations: an historical perspective." In *The Distribution of Money and Power*, eds. T. J. Courchene, D. Conklin, and G. Cook. Toronto: Ontario Economic Council, Special Research Report, vol. 2, pp. 107-43.

Marceau, N., and R. W. Boadway [1991]. "The redistributive role of minimum wage legislation and unemployment insurance." Queen's University Discussion Paper no. 805, Kingston, Ont.

Maxwell, J., and C. Pestieau [1980]. *Economic Realities of Contemporary Confederation*. Montreal: C. D. Howe Research Institute.

McLure, C. [1983]. *Tax Assignments in Federal Countries*. Canberra: Australian National University Press.

McMillan, M. ed. [1991]. *Provincial Public Finances*. Toronto: Canadian Tax Foundation, vols. 1 and 2.

Migué, J. L. [1991]. "Institutionalizing competition between governments: a return to true federalism." Paper submitted to the Quebec parliamentary commission on the political and constitutional future of Quebec (The Bélanger-Campeau Commission), Quebec.

Milne, D. [1991]. "Equality or asymmetry: why choose?" In *Options for a New Canada*, eds. R. L. Watts and D. M. Brown. Toronto: University of Toronto Press, pp. 285-307.

Mirrlees, J. A. [1971]. "An exploration in the theory of optimal income taxation." *Review of Economic Studies* 38:175-208.

Musgrave, R. A. [1959]. *The Theory of Public Finance*. New York: McGraw-Hill.

Nichols, A. L., and R. J. Zeckhauser [1982]. "Targeting transfers through restrictions on recipients." *American Economic Review* 72:372-77.

Oates, W. E. [1972]. *Fiscal Federalism*. New York: Harcourt Brace Jovanovich.

Ontario Economic Council [1983]. *A Separate Personal Income Tax for Ontario*. Toronto: Ontario Economic Council.

Parliamentary Task Force on Federal-Provincial Fiscal Arrangements [1981]. *Fiscal Federalism in Canada*. Ottawa: Supply and Services, also referred to as the Breau Report.

Pauly, M. V. [1973]. "Income distribution as a local public good." *Journal of Public Economics* 2:35-58.

Québec, Chambre de Commerce [1991]. "L'avenir politique et constitutionnel du Québec : sa dimension économique." Paper submitted to the Quebec parliamentary commission on the political and constitutional future of Quebec (The Bélanger-Campeau Commission), Quebec.

Rawls, J. [1971]. *A Theory of Justice*. Cambridge (Mass.): Harvard University Press.

Roberts, K. [1984]. "The theoretical limits to redistribution." *Review of Economic Studies* 51:177-95.

Rowell-Sirois Commission [1940]. *Report of the Royal Commission on Dominion-Provincial Relations*. Ottawa: King's Printer.

Sadka, E. [1976]. "On progressive income taxation." *American Economic Review* 66:931-35.

Stiglitz, J. E. [1987]. "Pareto efficient and optimal taxation and the new welfare economics." In *Handbook of Public Economics*, eds. A. J. Auerbach and M. Feldstein. Amsterdam: North-Holland, vol. 2, chap. 15.

Swinton, K. E., and C. J. Rogerson, eds. [1988]. *Competing Constitutional Visions: The Meech Lake Accord*. Toronto: Carswell.

Tiebout, C. M. [1956]. "A theory of local expenditures." *Journal of Political Economy* 64:416-24.

Trebilcock, M., et al., eds. [1983]. *Federalism in the Canadian Economic Union*. Toronto: University of Toronto Press.

Tuomala, M. [1990]. *Optimal Income Tax and Redistribution*. Oxford: Clarendon Press.

Vaillancourt, F. [1991]. "The division of powers in Canada: theory, evidence and proposals for Quebec." In *Economic Dimensions of Constitutional Change*, eds. R. W. Boadway, T. J. Courchene, and D. D. Purvis. Kingston, Ont.: John Deutsch Institute for the Study of Economic Policy, forthcoming.

Watson, W. [1986]. "An estimate of the welfare gain from fiscal equalization." *Canadian Journal of Economics* 19:298-308.

Winer, S., and D. Gauthier [1982]. *Internal Migration and Fiscal Structure: An Economic Study of the Determinants of Interprovincial Migration in Canada*. Ottawa: Supply and Services Canada.

Economic Council
of Canada

P.O. Box 527
Ottawa, Ontario
K1P 5V6

Conseil économique
du Canada

C.P. 527
Ottawa (Ontario)
K1P 5V6